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INTRODUCTION

Economic Reform in China

James A. Dorn

> China's reform process has both mass and acceleration. A collision of reform and special interests must come with great force at some point in time.
>
> —Steven N. S. Cheung

The Collision Course

The momentous changes occurring in China support Steven Cheung's concern with the collision course of economic liberalization and the incentive of China's nomenklatura, or ruling elite, for maintaining the status quo. Over the past decade China has made significant progress in transforming its bureaucratic system of state planning into a more market-oriented economic regime. The agricultural reform, in which individual farmers were given more effective ownership and control rights over the land at their disposal, saw a flourishing of activity in the countryside. Agricultural production increased dramatically and the newly created wealth spilled over into the formation of thousands of small-scale private enterprises producing a variety of products. Nevertheless, the dynamism that has characterized the agricultural sector has been largely absent in trade and industry, where the state continues to hold sway over economic life.

The persistence of state-owned enterprises and the lack of competition in trade and industry have hampered economic reform in China. The inefficiency of state enterprises has led to a vast network of subsidies,[1] and the deficits of state enterprises have been financed

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[1]In 1988, subsidies to state-owned enterprises amounted to nearly $11 billion—a figure representing about 50 percent of the earnings of China's industrial enterprises (Southerland 1988, p. F5).

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to an increasing extent by bank credits. The resulting inflation, now in the range of 20–30 percent, is seriously eroding support for further economic liberalization. But the real culprit is the iron grip the state still has on all important aspects of economic life and the refusal of the elite to bow to the forces of the marketplace.

The Failure of Piecemeal Reform

The current situation in China points once again to the failure of piecemeal reform and especially to the impossibility of establishing viable markets and prices without ownership reform and the establishment of private property rights. In particular, a sound constitutional framework, which insulates economic life from political opportunism, appears as a necessary condition for social and economic stability in China. The current corruption that is splitting China at the seams really stems from the ruling elite's vast power over economic and personal freedoms. Ultimately, economic and political reform are inseparable. As long as a Chinese wall surrounds the ruling elite—preventing the free flow of market information and the free expression of ideas—the quest for economic and social stability will fail to be realized.

At the heart of China's chaos, then, is a massive government failure: namely, the failure to establish an effective constitutional framework limiting the power of government officials over the economic and social life of the nation. The problem of how to curtail the influence of special interests and move the economic reform forward, while at the same time satisfying the demands for greater political freedom, is a classic issue in public choice theory. The rent seeking that characterizes democratic governments in the West, and which stems from an erosion of the economic constitution of liberty (as discussed in the writings of F. A. Hayek and others), is widespread in China where the rule of law has been supplanted by the rule of men.

When enterprises are owned and controlled by the state, economic decisions necessarily become political decisions, and impersonal price competition is supplanted by forms of personal competition driven by the quest for political power and privilege. Bribery and corruption then become the rule rather than the exception. The resulting uncertainty surrounding economic transactions acts as a destabilizing influence on economic development. This predicament has clearly been true of China's mixed economy as it has tried to force itself free from the grip of the nomenklatura, who have so far refused to decontrol markets and prices in a large segment of China's vast economic landscape.

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Constitutional Order and Economic Order

The problems of implementing a market-oriented reform in China and the prospects for transforming China's "ossified order" of state planning into a vibrant open society were the focus of the Cato Institute's conference on **Economic Reform in China: Problems and Prospects** held last September in Shanghai and cosponsored with Fudan University. The papers in the first part of this volume focus on the interconnection between constitutional order and economic order, and point to the difficulty of instituting price reform without ownership reform.[2]

With Hong Kong reverting to Chinese control in 1997, the path that China now follows will set up expectations that will shape the transition of Hong Kong. Any deviation from a market-oriented reform and an increased degree of freedom will destabilize the transition process and lead to economic and social chaos. The essays in this volume offer various proposals for achieving economic and social stability in China, and point to the importance of establishing constitutional safeguards for economic and personal freedoms. The privatization of state-owned enterprises and the introduction of competitive markets to replace state monopolies may appear radical to Chinese conservative leaders; but where it has been tried in Special Economic Zones (SEZs), the success has been resounding. The challenge now facing China is whether to continue on a piecemeal reform and suffer the fate of earlier Soviet and Eastern European reforms or to institute thoroughgoing ownership and price reform, thereby enhancing the prospect of achieving a spontaneous market order that could make China an economic giant in the next century.

The essays here draw from experience in the West, in Hong Kong, and in the Pacific Rim—and utilize recent developments in constitutional economics and public choice theory—to offer China guidance in mapping out a path toward long-lasting stability and prosperity. A major lesson is that economic order and stability ultimately require a constitution of liberty, in the Hayekian sense. Self-interest can then be harnessed for the wealth of the nation rather than deteriorate into a rent-seeking society. Experience has proven that private property, freedom of contract, and basic political freedoms are the indispensable basis for a dynamic economic order, and that information is best utilized via decentralized markets and prices.

[2]The complete set of conference papers will be published in the United States by the University of Chicago Press and in China by Fudan University Press. The forthcoming book is entitled *Economic Reform in China: Problems and Prospects*, coedited by James A. Dorn and Wang Xi.

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China's experiment with central planning is now judged a dismal failure by virtually everyone. The coordination of over one billion people cannot be accomplished by social engineering, without a great loss of freedom and prosperity. The free-market order, grounded on a rule of law, offers an alternative to secure the freedom and prosperity desired by the Chinese people. These basic desires cannot long be suppressed without increased corruption and inefficiency. Thus, the real issue facing China is not whether reform is necessary but how fast and how far to go. As Zhao Ziyang stated: "Without reform there will be no way out for China. If reform is not carried out today, it will have to be carried out in the future, but that will only prolong China's backwardness."[3]

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[3]Quoted in Abrams (1988, p. 15C).

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Using the Market for Social Development

Milton Friedman

Introduction

An episode during an earlier visit to China impressed me strongly with the wide gulf of understanding that separates people immersed in different economic institutions. That gulf makes it extremely important to stress over and over basic principles and ideas that all of us simply take for granted with respect to the system to which we are accustomed. The episode in question occurred when my wife and I had lunch with a deputy minister of one of the government departments who was shortly going to the United States to observe the American economy. Our host wanted help from us on whom to see.

His first question in that connection was, "Who in the United States is in charge of materials distribution?" That question took my wife and me aback. I doubt that any resident of the United States, however unsophisticated about economics, would even think of asking such a question. Yet it was entirely natural for a citizen of a command economy to ask such a question. He is accustomed to a situation in which somebody decides who gets what from whom, whether that be who gets what materials from whom or who gets what wages from whom.

My initial answer was to suggest that he visit the floor of the Chicago Mercantile Exchange where commodities such as wheat, cotton, silver, and gold are traded. This answer understandably baffled our host, so I went on to elaborate on the fact that there was no single person—or even committee of persons—"in charge of materials distribution." There are a Department of Commerce and a

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Department of the Interior that are concerned with materials production and distribution in a wholly different way. But they do not determine who gets how much of what. They collect information, examine the situation in various industries, evaluate legislation, and so on. Legislation (for example, tax and foreign trade laws) certainly affects the course of materials prices and distribution, but no single person or political body is "in charge of materials distribution" in the sense in which there is or has been such a person or political body in China or the Soviet Union. In consequence, I was forced to answer in terms that my host found extremely difficult to comprehend. Needless to say, that is not a criticism of him. Given his background, it is almost inconceivable that he could have understood how the market can distribute a variety of materials among millions of different people for thousands of uses untouched, as an ad might say, by political hands.

The miracle of the market is precisely that out of the chaos of people screaming at one another, making arcane signals with their hands, and fighting on the floor of the Chicago Mercantile Exchange, somehow or other the corner store always seems to have enough bread, the bakery always seems to have enough flour, and the miller always seems to have enough wheat. That is the miracle of the way the market coordinates the activities of millions of people, and does so in a wholly impersonal way through prices that, if left completely free, do not involve any corruption, bribes, special influence, or need for political mechanisms.

Let me now turn more directly to the topic at hand. In some ways, referring to "the market" puts the discussion on the wrong basis. The market is not a cow to be milked; neither is it a sure-fire cure for all ills. In literal terms, the market is simply a meeting of people at a specified place and time for the purpose of making deals. Needless to say, "meeting" and "place" are often euphemisms; they do not involve physical getting together. As of the moment, there is a market in foreign exchange that encompasses the world. People get together through satellites, telephones, and other means. Moreover, the deals made in or through a market are not restricted to those involving money, purchases, or sales. Scientists who cooperate with one another in advancing their discipline, whether it be physics, chemistry, economics, or astronomy, are effectively making deals with one another. Their market is a set of interrelated journals, conferences, and so on.

The market is a mechanism that may be mobilized for any number of purposes. Depending on the way it is used, the market may contribute to social and economic development or it may inhibit such development. Using or not using the market is not the crucial dis-

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tinction. Every society, whether communist, socialist, social democratic, or capitalist, uses the market. Rather, the crucial distinction is private property or no private property. Who are the participants in the market and on whose behalf are they operating? Are the participants government bureaucrats who are operating on behalf of something called the state? Or are they individuals operating directly or indirectly on their own behalf?

That is why, in an earlier paper delivered in China, I advocated the widest possible use not of the market but of "free private markets" (Friedman [1980] 1982). The words "free" and "private" are even more important than the word "market." The wider use of the market that is sweeping the world is better described as "privatization"—transferring government-owned enterprises to private hands and thereby giving greater scope to the invisible hand of which Adam Smith wrote. In 1987 alone, over $90 billion of assets and enterprises were privatized by governments around the world.

In this paper I propose to discuss some of the problems that arise when a society tries to replace a command economy with the invisible hand of the market. Those problems are not restricted to societies that have tried to use command as their basic economic mechanism, such as China and the Soviet Union. The same problems arise in Western economies, such as the United States, Great Britain, and Germany, in which command elements have become more extensive over time and in which there are attempts to reverse that process. Privatizing government-owned enterprises in the West, such as the postal service in the United States and railroads and utilities in other countries, raises problems that are identical with those that arise in replacing command and government ownership by voluntary cooperation and private ownership in China and the Soviet Union. In consequence, China can learn a great deal by studying the experience of privatization in Western countries. At the moment, the most extensive experience of that kind is doubtless in Great Britain. Much has been written about the British experience, and it provides many instructive examples about correct and incorrect ways to privatize.[1]

I shall organize my discussion under three headings: partial versus total decontrol (or deregulation or privatization); gradual versus immediate decontrol; and overcoming political obstacles or, in more technical economic terms, short-circuiting rent seeking. Although the same issues arise whatever the domain in which command is replaced by voluntary cooperation—whether economic, political, or social—I shall restrict my comments to the economic domain. A

[1]An excellent source for Britain and other countries is Hanke (1987).

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concluding section discusses the general problem of the tyranny of the status quo.

Partial versus Total Decontrol

Introducing a greater role for private market mechanisms in one sector of an economy may be partially or completely frustrated by the limited scope of the change. Consider what has been regarded as a major move toward wider use of the market, namely creation of the European common market and the attempt to achieve free trade among the common market countries. It has now been nearly 40 years since the Schuman plan for a coal and steel community was adopted, yet no observer will dispute that free trade within the common market is still an ideal rather than a reality. The latest bit of evidence is the recent agreement to *really* eliminate all barriers by 1992. Had the initial common market agreement been successful, that elimination would have been achieved many years ago. What was the problem? Why is there no real United States of Europe? In my view, the answer is that decontrol was adopted even in principle only for goods and services but not for money. The separate countries retained full authority over their national moneys. More important, they refused to adopt a system of freely floating exchange rates—that is, the free exchange of one currency for another at whatever rates of exchange were voluntarily agreed to in free private markets. The refusal to let the private market determine the rates of exchange among currencies was a fatal weakness.

I first reached that conclusion in the fall of 1950 when I spent a few months as a consultant in Paris to the then Marshall Plan agency. My assignment was to assess the likely consequences of the proposed coal and steel community. I concluded that free trade within a common market could not be achieved unless currencies as well as goods and services were freed from government control. That analysis was the basis for my article on "The Case for Flexible Exchange Rates" published in 1953. As I stated in that article (p. 157):

> A system of flexible or floating exchange rates—exchange rates freely determined in an open market primarily by private dealings and, like other market prices, varying from day to day—[is] absolutely essential for the fulfillment of our basic economic objective: the achievement and maintenance of a free and prosperous world community engaging in unrestricted multilateral trade. . . . Liberalization of trade, avoidance of allocations and other direct controls, both internal and external, harmonization of internal monetary and fiscal policies—all these problems take on a different cast and become far easier to solve in a world of flexible exchange rates and its corollary, free convertibility of currencies.

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Experience during the 35 years since that article was published has, I believe, provided much additional evidence for the validity of this proposition.

Currently, China is faced with precisely the same problem. But my purpose in discussing it here is not to present again the case for a system of freely floating exchange rates but rather to give a striking illustration of how limiting decontrol or privatization to one area, while not extending it to closely related areas, can largely frustrate the basic objective.

A second example is from the United States. Although nominally private, U.S. airlines were subject to extensive government control with respect to the prices they could charge and the markets they could serve. Deregulation of the airlines in 1978 has enhanced competition, resulted in widespread and substantial reductions in prices, and increased the range of services. In consequence, there has been a major expansion in the volume of air traffic. However, while U.S. airlines were deregulated or, as I would prefer to put it, privatized, airports were not. They remain government-owned and operated.[2] Private enterprise has had no difficulty in producing all the planes the airlines find it profitable to use, and private airlines have had no difficulty in finding pilots or attendants. On the other hand, planes are often delayed because facilities or provisions for landing them at government-run airports are inadequate, at great inconvenience to passengers. Naturally, the government responds by trying to blame the private airlines: It has started requiring them to report delays in meeting their scheduled arrival times and publishing summary reports on the on-time performance of the several airlines. Repeated proposals have been made that—even if government retained the ownership and operation of the airports—rights to gates, both with respect to number of gates and to the times at which they are to be used, should be auctioned off. Unfortunately, the opposition of airlines, which have vested interests in the gates and times assigned to them by government agencies, has prevented the adoption of even such incomplete reforms. Of course, a far better solution would be to privatize the airports.

A third example is privatizing some areas of manufacturing while keeping the production or pricing of the raw materials under government control. The failure of the prices of the raw materials to conform to their market value means that private operation, however efficient privately, may be socially wasteful. Let me illustrate with an extreme

[2]In Britain, however, the British Airports Authority, which controls some airports, has been privatized.

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example that I came across in India many years ago. It had to do with the manufacture of bicycles in a small community in the Punjab. The government of India controlled the production of steel and rationed the output to users, rather than auctioning off the steel produced at whatever prices the market would yield. As a result, the producers of bicycles could not get the amount of steel they were willing to buy at the officially set price of steel. However, there was a private market in finished or semifinished steel products. The bicycle manufacturers supplemented their government ration of steel by buying semifinished steel products and melting them down—hardly an efficient way to convert iron ore and coal into bicycles.

Let me cite some obvious examples for China. Introduction of a considerable element of privatization in agriculture has produced a remarkable increase in agricultural output and productivity—the most dramatic manifestation of China's success in widening the use of the private market. But it is clear that the very success has created a real problem. The overwhelming majority of the Chinese population is employed in agriculture. Even a relatively small improvement in agricultural productivity means the release from agriculture of workers who can now be more usefully employed in industry. Yet, the bulk of industry remains in the command economy; it has not been privatized, deregulated, or fully subjected to the competitive market process.

There has been a real attempt to change the way government-owned enterprises operate in China. The people in charge have been told to use market mechanisms, and an attempt has been made to provide incentives for them to do so. However, as long as industrial enterprises are government-owned, there are severe limits to the ability of politically sensitive managers (bureaucrats) to respond effectively to market pressures. The most serious limitation is on flexibility, that is, on the willingness or ability of managers in state-owned enterprises to be venturesome, to undertake risky projects that are likely to fail but have a real, if small, chance of spectacular success. Again, the problem is universal. Every study of the United States or Great Britain demonstrates that small enterprises—not the mega-corporations that are household names—are responsible for most of the new jobs. In China, the opportunity for such private enterprises is narrowly limited.

A much wider privatization of economic activity would greatly reduce the difficulty of absorbing the workers released from agriculture. That is precisely what happened in the United States and in the rest of the world during the 19th and 20th centuries. The fraction of the American population employed in agriculture in the early 19th

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century was over 90 percent—not far from the fraction currently employed in China—but it is now 2 or 3 percent. True, the transition in the West took much longer and proceeded at a more gradual pace than either should be or can be hoped for in China. Nonetheless, if the command sector of the economy had been as extensive in the United States then as it is now, let alone as extensive in China, the transition would never have occurred to anything like the same extent. The experience of Russia over the past 70 years is persuasive evidence. The way to expedite the transition in China is to proceed with privatization as rapidly and on as wide a scale as possible. Private enterprises would then spring up all over the place to absorb the working force.

A second example for China is similar to the problem I described for the common market: the difference between the extent of freedom in the production and distribution of goods and services and in the production and distribution of money. The substantial freeing of many prices, particularly those of agricultural and similar goods, has not been accompanied by the privatization of the banking system. As I understand it, the Chinese government indirectly determines what happens to the money supply through the credits it grants state enterprises. One result has been a rapid increase in the quantity of money and, not surprisingly, rapid upward pressure on prices, so that inflation, both open and repressed, has reared its ugly head.

It is much easier to point out the problems raised by partial use of the market than it is to draw any explicit implications for policy. It is easy to say that the best thing to do is to go all the way. However, in many really interesting and important cases, it is simply not politically feasible to do so. It would be clearly helpful in such cases to have some maxims that would suggest a way to draw the boundaries. However, it is not easy to do so in the abstract. I suspect that the only possible way to proceed is to analyze each case separately in light of the general economic principles embodied in price and monetary theory.

Gradualism versus Shock Treatment

When should reform be gradual, and when is radical and immediate change appropriate? One alternative is illustrated by the tale of the tortoise and the hare, when the "slow but steady" tortoise reaches the finish line ahead of the much speedier but more erratic hare; The other is illustrated by the maxim, there is no sense in cutting a dog's tail off by inches. This is one of the most difficult problems encountered in widening the scope of the market. Let me

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illustrate with foreign trade. Suppose a country that has had high levels of tariffs decides to move to a free trade position. The case for moving gradually is clear. Capital has been invested in ways that will no longer represent an effective use of private resources under the new conditions. Much of that capital is in the form of machinery, buildings, human skills, and the like. Is it not clearly both more equitable and more efficient to reduce the tariffs gradually? That would give the owners of specialized resources the opportunity to withdraw their capital gradually and thus would reduce the costs imposed on them by the change.

The case for eliminating the tariff in one fell swoop, that is, for shock treatment, is more subtle, yet at the level of economic efficiency, compelling. Insofar as it is economically efficient to use the specialized resources in the absence of a tariff, they will be used. If any return over marginal cost can be obtained by continuing to use the specialized human and other resources, it is better to get that return than to get nothing. The burden would be imposed on the owners of the specialized resources immediately, but technical disinvestment would proceed only as rapidly as the specialized labor and other resources could be employed more productively elsewhere. On the other hand, gradual reduction in the tariff makes it privately profitable to continue using the specialized resources at a higher level than is socially efficient, thereby imposing unnecessary costs on the community.

The possibly valid arguments for gradualism are not technical and economic but equitable and political, and neither of these is clear-cut. The individuals who invested in the protected industries did so with the full knowledge that the authorities that imposed the tariffs could eliminate them. The existence of such a possibility kept down the amount of capital invested in the industry and permitted the owners of such capital to earn a higher return than otherwise. Why is it now equitable for consumers to bear part of the owners' costs of adjustment? Politically, gradualism encourages the protected industries to spend resources to reverse the decision.

The analysis is complicated even further by considering the activities that will tend to expand under the new circumstances, that is, the industries that will replace the former so-called protected industries. Here, too, issues about efficiency, equity, and politics require attention.

Ending an ongoing inflation raises similar problems. Eliminating inflation in one fell swoop, if not anticipated long in advance, may cause widespread capital losses. Long-term contracts entered into with one expectation about the likely rate of inflation may now sud-

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denly be rendered inappropriate. The case on equity grounds for a gradual transition is far stronger for moderate degrees of inflation than for tariffs. The effects of both the prior inflation and its unanticipated ending are more pervasive and affect more people who have not only been harmed rather than benefited by the prior inflation but would be harmed again by its abrupt end. Reducing inflation gradually eases the transition and reduces the cost of achieving noninflationary growth.

However, much depends on the height of the inflation. If inflation is extremely high—at annual rates in triple digits—the situation is very different. Almost all participants in the market will have adjusted their arrangements so that any longstanding commitments are fully indexed. Abrupt disinflation will impose few costs because financial and other institutions have been adapted to radical changes in the rate of inflation. Indeed, such adaptations represent a major cost of high and erratic inflation. Gradual elimination is sometimes not even feasible because there is not time enough—the dog will be dead before its extra long tail can be cut off by inches.

Direct controls over prices—whether general or specific, for example, on rents or exchange rates—are almost always best ended at once. Margaret Thatcher properly ended exchange rate controls in Britain overnight and completely. Gradual adjustment only prolongs the harm done by controls and provides unjustified benefits to "insiders." The shortages and queues and other distortions produced by trying to hold prices below their market level would continue though they might get shorter, and additional problems arise because gradualism encourages speculation about reversal and encourages opponents to seek reversal. A similar proposition holds for attempts to keep prices above market levels—as is so amply demonstrated by the agricultural policies of the United States, Japan, and the common market.

Overcoming Political Obstacles

This subject has already inevitably intruded into the preceding section. The general issue here is how to overcome political obstacles to widening the market. The danger is not alone that these obstacles will frustrate the attempt to free the market but equally that overcoming political obstacles will destroy the advantages of freeing the market. The challenge is to find ways to overcome obstacles that do not have those effects. The experience of the West with privatization is particularly helpful in this connection. Perhaps the most extensive body of experience and the experience that has been most widely

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analyzed is the British experience with privatization, and I strongly recommend to our Chinese friends seeking to widen the market that they examine the evidence of privatization in Britain.

A simple case from the United States that illustrates the problem is privatizing the post office. The U.S. Postal Service has a monopoly in first-class mail because of the private express statutes, which make it a crime for individuals to offer common-carrier first-class service. Various attempts to do so have only succeeded in prosecution, which has ended the attempts. Privatization has been creeping in at the margin, first in the form of alternate parcel service. The United Parcel Service, a strictly private enterprise, and other parcel delivery companies have taken over the bulk of the Postal Service's prior business. In addition, private messenger services have developed, of which the best known is Federal Express, which has been so successful that numerous competitors have emerged. Developments that technological advances would have encouraged no matter how postal service was organized have doubtless been speeded up. Examples are electronic mail via computers and telephones, and facsimile service, again over telephones. These examples illustrate the ingenuity of private markets in exploiting the opportunities offered by the inefficiency of government enterprises.

Repeated attempts have been made to seek the repeal of the private express statutes so that private individuals and enterprises could compete with the U.S. Postal Service. However, such attempts always bring violent protests from the postal employee unions, from the executives of the Postal Service, and from rural communities that feel they would be deprived of postal service. On the other hand, few people have a strong and concentrated interest leading them to favor repealing the private express statutes. Entrepreneurs who might in fact enter the business if it were open to private entry do not know in advance that they would do so. Hundreds of thousands of people who would doubtless obtain employment in a privately developed postal system do not have the slightest idea that they would do so.

I recall a personal experience. I urged a congressman who believed as strongly as I did that it would be desirable to repeal the private express statutes to introduce a bill to that effect. He said, "You and I know the powerful groups who will testify and lobby against such a bill. Can you give me a list of people who will be equally willing to testify and work in favor of such a bill? People who will have some influence on Congress? People with a strong personal interest other than academic economists?" I admitted that I could not do so and he never introduced the bill. Vested interests have been built up in the postal monopoly. Few vested interests have been built up in oppos-

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ing the postal monopoly, though there are some. That situation may be changing as corporations such as Federal Express and United Parcel Service begin to see the possibilities open to them.

One way to overcome the opposition to privatization, widely used in Britain, is, as described by Robert Poole (1988, p. 25),

> to identify potential opponents and cut them in on the deal, generally by means of stock ownership. Two specific applications of the principle are employee stock ownership and popular capitalism. . . .
>
> The opportunity to become shareholders can dramatically change the incentives of unionized civil servants, as illustrated in the case of British Telecom. Union officials denounced the planned privatization of Telecom, telling their members not to purchase the shares which were being offered to them at a discount. Yet in the end, sensing the chance to make money, some 96 percent of the workforce bought shares.

Poole also uses British Telecom to illustrate the second technique, popular capitalism: "To encourage telephone customers to buy shares, they were offered vouchers granting them a discount on their phone bills if they held their shares for at least six months. And to prevent institutions and large firms from buying up the lion's share, initial purchases were limited to 800 shares per buyer."

A pitfall to be avoided in adopting such expedients is to sweeten the deal by converting a government monopoly into a private monopoly—which may be an improvement but falls far short of the desirable outcome. The U.S. Postal Service illustrates that pitfall as well as the fallacy that mimicking the form of private enterprise can achieve the substance. It was established as a supposedly independent government corporation that would not be subject to direct political influence and that would operate on market principles. That has hardly been the outcome, and understandably so. It remained a monopoly and never developed a strong private interest in efficiency.

My own favorite form of privatization is not to sell shares of stock at all but to give government-owned enterprises to the citizens. Who, I ask opponents, owns the government enterprises? The answer invariably is, "The public." Well, then, why not make that into a reality rather than a rhetorical flourish? Set up a private corporation and give each citizen one or one hundred shares in it. Let them be free to buy or sell the shares. The shares would soon come into the hands of entrepreneurs who would either maintain the enterprise, for example, the postal system, as a single entity if it was most profitable to do so or break it up into a number of entities if that seemed most profitable. I know only one major case in which this

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procedure was followed, namely in British Columbia (see Ohashi and Roth 1980, part 1). Unfortunately, the collapse of energy prices made this venture less than an outstanding success. Nonetheless, it is well worth studying.

A final example illustrates the point in another way. The Russians have permitted small private plots in agriculture. Those private plots are estimated to occupy about 3 percent of the arable land in the Soviet Union, and roughly one-third of all domestic food products in the Soviet Union are sold as coming from those private plots. I have chosen my words carefully. I did not say that one-third were "produced on those private plots," because in my opinion that would not be correct. Much of the food sold as coming from the private plots has indeed been produced on them, but I strongly suspect that much has also been diverted from collective farms.

For decades, it has been clear to the rulers of the Soviet Union that they could increase the domestic output of agriculture substantially by increasing the size and role of the private plots. Why have they not done so? Surely not because of ignorance. The answer clearly is that privatization would tend to establish independent centers of power that would reduce the political power of the bureaucracy. The rulers regarded the political price they would have to pay as higher than the economic reward. As of the moment, largely I suspect under the influence of the extraordinary success of such a policy in China, President Gorbachev is talking about a considerable expansion in private plots. It is by no means clear whether he will succeed.

Tyranny of the Status Quo

The problems of overcoming vested interests, of frustrating rent seeking, apply to almost every attempt to change government policy, whether the change involves privatization, or eliminating military bases, or reducing subsidies, or anything else. The resulting "Tyranny of the Status Quo," as my wife and I entitled a recent book (Friedman and Friedman 1984) discussing a range of such cases in the United States, is the major reason that political mechanisms are so much less effective than free-market mechanisms in encouraging dynamic change, and in producing growth and economic prosperity.

Few simple maxims exist for overcoming the tyranny of the status quo. But there is one that ties in closely with the earlier discussion of gradual versus abrupt change. If a government activity is to be privatized or eliminated, by all means do so completely. Do not compromise by partial privatization or partial reduction. That simply leaves a core of determined opponents who will work diligently and

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often successfully to reverse the change. The Reagan administration repeatedly attempted, for example, to privatize Amtrak (the railroad passenger service) and to eliminate the Legal Services Corporation. In each case, it settled for a reduction in budget, achieving a fairly transitory victory. On the other hand, the complete abolition of the Civil Aeronautics Board gives far greater hope that airline deregulation is here to stay.

In conclusion, there are better and worse ways to privatize a command economy, but there is no magic formula for shifting painlessly from a command to a voluntary exchange economy. Nonetheless, the potential rewards are so great that, if the shift can be achieved, transitional costs will pale into insignificance. It is a tribute to the current leaders of China that they recognize that the potential gains dwarf the transitional costs and that they are engaged in a serious effort to make the transition. The Chinese people would be the main but by no means the only beneficiaries of the success of this effort. All the peoples of the world would benefit. Peace and widely shared prosperity are the ultimate prizes of the worldwide use of voluntary cooperation as the major means of organizing economic activity.

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Planning and the Market

Pu Shan

Socialism in Theory and Practice

In economic literature, the question has long been raised whether the socialist system based on public ownership of the means of production could effectively organize economic activities. One point of view is that the socialist system is incompatible with the market mechanism and therefore cannot rationally allocate resources and organize economic activities. As early as the 1920s, Ludwig von Mises had argued strongly for this viewpoint. Oscar Lange, Abba Lerner, and others, however, offered the counterargument and demonstrated that in theory the socialist system could also make use of the market principle. Although their argument has sometimes been labeled "playing the game of competition" or "playing at capitalism," the theoretical question is basically resolved.

Another point of view is that although the socialist system could in theory make use of the market mechanism, public enterprises lack the incentive to observe the market principle and therefore cannot respond effectively to market pressures. Friedrick Hayek has long been of that opinion. Professor Friedman's argument seems to belong to the same category. The practical problem does exist. Since no socialist country has yet had a completely successful experience in making use of the market, it should be recognized that this practical problem remains unresolved.

The Direction of China's Economic Reform

The direction of China's economic reform is toward the development of a planned commodity economy based on socialist public ownership and not toward what Friedman calls "free private mar-

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kets." After the founding of the People's Republic in 1949, a vast amount of manpower, materiel, and financial resources were mobilized for large-scale economic development. Under a planned economy, with a relatively comprehensive industrial structure, China met the basic needs of the masses and achieved remarkable success. Nevertheless, the neglect of the role of the market mechanism, the overcentralization of the planning system, and the lack of production units with autonomous decisionmaking power affected more and more seriously the vitality of the economy. One of the important tasks of the current economic reform is to allow full play to the positive role of the market mechanism. Mandatory planning, therefore, is to be replaced by "guidance planning," the scope of prices set by the state is to be reduced, and the scope of prices determined by the market expanded. Moreover, even mandatory planning and state-set prices should take full account of market responses and the role of the law of value. The overall direction is "the state regulates the market and the market guides the enterprises."

Economic reform also bears on the question of ownership. The socialist economic system is based on public ownership of the means of production, including state ownership (mainly in the form of state enterprises) and collective ownership. In the past, however, there was an overemphasis on state ownership and a neglect of collective ownership, especially the necessary supplementary role of individual private ownership. A major component of the reform is to develop actively collective and individual economies while maintaining the basis of public ownership, and to develop extensively various forms of contractual management and cooperative management among the state, collective, and individual economies on a voluntary and mutually beneficial basis. China does not intend to privatize extensively its state enterprises. But in these enterprises, there will also be a separation of ownership and management, and through such measures as the management contract system the interests of the managers will be directly related to the economic efficiency and the profits and losses of the enterprises. Under these provisos, China is experimenting with stock ownership. The purpose is to render the state enterprises more responsive to market adjustments.

In this connection, Professor Friedman mentioned the very important problem in China of transferring agricultural workers to industry. The actual situation is that during the process of economic reform in China, the rapid development of rural village and township enterprises has played a remarkable role in absorbing surplus agricultural workers. In recent years, the number of workers absorbed in village and township enterprises has been increasing by close to 10 million

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annually. These enterprises are mainly collective enterprises established by towns and villages.[1] In 1987, the number of workers in village and township enterprises amounted to 88 million, and their output value accounted for one-fourth of the total value of industrial output of the whole country. It is noteworthy that the large-scale transfer of agricultural labor to industry has been accomplished amid unprecedented prosperity in the rural economy, unlike many other countries that went through the painful process of widespread bankruptcy of farmers during the 19th and 20th centuries.

The economic efficiency of China's state enterprises is still far from being satisfactory. China's economic reform is also faced with many difficulties. There is still no sufficient factual evidence, therefore, to prove that the planned commodity economy based on Chinese-style public ownership will necessarily be superior to an economic system based mainly on "free private markets." On the other hand, judging from the actual evidence, any opposite conclusion seems also unwarranted.

The Extent and Rapidity of Reform

Professor Friedman also raised the problems of "partial versus total decontrol" and "gradual versus immediate decontrol" in economic reform. These are very pertinent issues in the economic reform in China. "Partial versus total" and "gradual versus immediate" are of course relative concepts and closely related concepts. Relative to complete "free private markets," a planned commodity economy based on public ownership might be considered as a kind of partial reform. But no significant reform can be accomplished overnight, and any gradual reform inevitably creates continuous situations of partial reform.

China's economic reform has adopted the approach of gradual implementation. Judging from the actual situation in China, this approach has avoided irretrievable mistakes in the reform and serious volatility in economic activities. Moreover, through continuous demonstration of the practical benefits of economic reform, the gradualist approach has reduced resistance to reform. But this approach also has created the coexistence of the old and the new system and has created many new difficulties. For instance, at the present time, there are different prices for many of the same products, which has led to serious malpractices. As such, price reform is increasingly becoming

[1]According to 1985 statistics, collective enterprises accounted for about 60 percent of the workers in village and township enterprises, whereas other cooperative enterprises accounted for 13 percent and individual or private enterprises for 27 percent.

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the key to the whole economic reform. Yet price reform is seriously hampered by such constraints as inflationary pressures.

Price reform concerns the whole economic structure and there is no simple choice among "partial or total" and "gradual or immediate" approaches. What is important is to have a comprehensive and coordinated program, and the steps and speed of the implementation of this program should take into consideration the actual situation in various fields as well as their interrelationship. The State Council has already put forward a preliminary program of price and wage reform, and the program is under extensive discussion and examination.

The Question of Political Reform

The deeping of reform will inevitably involve adjustments of economic rights and benefits, and will therefore inevitably meet with political resistances and obstacles. This is why it is necessary to carry out political reform alongside economic reform. At the present time, the foremost task of political reform is to ensure the correct and successful implementation of the economic reform. But this task can rely only on the evolution and development of socialist democracy, rather than on such devices as "to identify the potential opponents and cut them in on the deal." From a long-run point of view, it is of vital importance that at the same time as material production is developed, the ideological and moral standards of members of society be raised—so as to establish gradually a new type of social relation among humankind. This is indeed the essence of socialism.

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Privatization vs. Special Interests: The Experience of China's Economic Reforms

Steven N. S. Cheung

In the span of 10 years since China opened her doors to the world, economic changes have taken place of a magnitude and speed that are simply awesome. Remembering what China was like a mere decade ago, we are compelled to think that her declared growth statistics, impressive though they certainly are, must be understated. Whatever the future holds, the recent Chinese experience will be remembered as one of the most significant economic events in history.

In 1981, I predicted China would go "capitalist" (Cheung 1982). With the single exception of Ronald Coase, all my friends objected that this judgment was far too optimistic. My prediction, stated in no uncertain terms, was that China, although probably never officially endorsing "private property," would nonetheless adopt a system akin to private property in practice.

Not even modesty can now suppress a temptation to claim perspicacity. Unfortunately, recent events confirm another judgment call I made three years ago: The easy part of China's economic reforms was coming to pass, and high hurdles that could not be overcome without bold actions would soon follow.

Outsiders and Chinese authorities alike identify the same baffling difficulties. Mounting inflation is coupled with ever-rising government spending. The government finds price controls increasingly difficult to finance, yet to relax them without a sharp rise in the wages of state employees beyond the government's budget constraint may lead to social unrest. This view of a two-sided problem is not wrong. However, I shall argue that the root of the difficulties lies in the

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deeply entrenched state-controlled monopolies designed to protect vested interests.

In this paper I begin with a brief discussion of China's success in promoting private property rights in land and in labor. I then turn to the difficulties likely to face any attempt to privatize state enterprises. Finally, the relationship between these issues and the current headline topics of China's inflation and financial problems will be considered.

The Creation of Private Property via Contracting

Whereas it has taken a revolution to abolish private property, the process in reverse may be done through peaceful contracting. It is not clear whether authorities in China were aware that the end result of the agricultural reforms initiated at the turn of the decade, is, for all practical purposes, a system of private property rights. Certainly the word "private" was avoided like a plague until March 1988. But as it turns out, the so-called responsibility contract, with all its modifications and refinements, is a Chinese version of the deed of trust.

"Responsibility" means that an individual household, or a set of households, assumes the task of production and payment to the government. In principle, the state imposes few additional restrictions, although in the industrial and business sectors numerous interventions remain. The development of the responsibility contract, with its attendant obstacles as well as implications for resource allocation, deserves a thorough study beyond the scope of this paper. It suffices here to quote from my 1986 "Postscript" to *Will China Go 'Capitalist'?* to pinpoint its nature (Cheung 1986, p. 67).

> The so-called "responsibility contract," if reduced to its simplest and therefore most perfect form, is equivalent to the granting of private property rights through a state lease of land. The duration of the lease may be any number of years or, in principle, it may be in perpetuity. Ownership is not relinquished by the state, but the rights to use and to obtain income are exclusively assigned to the lessee. The right to transfer or to sell the leased resource may take the form of sub-letting. Various dues exacted by the state may be lumped together in the form of a fixed rent, and since this rent is paid to the state it becomes a property tax. If indeed a perpetual lease is assigned, the land-holding becomes fee simple, and if the lease is freely transferable, the land is held in fee simple absolute—or private property in its perfect form!
>
> In ancient China, as in medieval Europe, there was no distinction between the meaning of "rent" and of "tax." A feudal lord who collected "rent" became a collector of "tax" when he assumed the role of a "government" in providing services such as justice and

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> protection. From this point of view, the evolution of the responsibility system in China has come close to repeating in three astonishing years the course of several centuries of development in medieval Europe.

Yes, the responsibility contract as applied in agriculture comes very close to what in the Western world is a grant of private property in land. The clear, if minor, departure is that the Chinese version takes the form of leasehold instead of fee simple; that is, the contract is not in perpetuity. The length of the responsibility contract varies considerably across different regions or for different types of crops, and there is a tendency for contracts of a more recent vintage to have longer terms. In some regions, local authorities stipulate no time limitation at all: Confidence in the leasehold therefore varies with political climate. With the passage of time the contract holders gradually assume the view that they have an implicit perpetual right.

The use of the leasehold method finds its counterpart in Hong Kong, where practically all land belongs to the Crown. Although in this and in other developments in China the influence of Hong Kong is unmistakable, there is no doubt that a contract falling short of a deed serves a vital political function. With a leasehold the ownership of land remains with the state, thereby excluding private property in title and permitting the preservation of an image of socialist ownership. Early on, the transfer of the contract—equivalent to selling land—was forbidden as a way to suppress capital gain, but even this restriction has been relaxed and in some localities it is entirely ignored.

The public auction of land for nonagricultural uses, which occurred for the first time on December 1, 1987, also falls short of fee simple. Here again the exclusion of outright sale preserves the title of state ownership. Yet in a true economic sense private property in land had been created, and with the recent explicit allowance of capital gain, not only Karl Marx has been forgotten but also Henry George. Significantly, in a public auction in Shanghai in July 1988, a Japanese firm was the winner. For the first time since the communist revolution, a foreigner had openly gained a private interest in China's soil. We may suppose the protection of private property of land will be generally strengthened: With any degree of foreign participation, any backward step is likely to have broader repercussions.

The establishment of private property rights in labor is even more prevalent than in land, although it has received much less attention. Unlike land, which itself makes no decision, every worker is a decisionmaking unit. Therefore, as soon as the government relaxes its control over labor, the individual would automatically assume responsibility for himself. In other words, labor becomes private

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property the moment it is not manipulated and controlled by the government.

The privatization of labor became evident about five years ago, when the authorities relaxed the requirement that all employment be assigned by the state. The unemployed (described as "waiting to be employed") were far too numerous, and the pressure from Hong Kong investors to hire labor by private contracting was far too great. The experiment of letting state employees take their chances with the market began in the Pearl River basin and gradually spread northward. Today, the state control of labor still found in Beijing is nonexistent in Southern China.

Individual households running their own small enterprises can now be found everywhere, and in Southern China even state-owned enterprises now refuse to hire state employees; rather, they opt for contract workers. In the South, the survival of the state-employee system in trade and industry is sustained by only three factors. First, state employees have guaranteed security and retirement benefits. Second, contract workers employed by state enterprises are subject to wage ceilings. And third, with most sizeable enterprises still owned by the state, employment opportunities are limited. Still, in a number of localities, particularly in areas where Hong Kong investors are popular, the state-employee system is quite literally falling apart.

Difficulties Confronting Trade and Industry

By 1985 the responsibility contract was well established in agriculture and China began to extend the system to state-owned enterprises in trade and industry. I noted in 1986 five problems encountered in trade and industry (Cheung 1986, pp. 68–69):

> First, productive assets such as a desk, a machine, a brand name, or know-how are not physically divisible like land, so the productive assets in a corporation are not owned exclusively by any specific member of the corporation. With many individuals working in a group, as in a typical state enterprise in China, rights over productive assets obviously cannot be delineated in the way lands are divided among individual peasant households. In the absence of any clearly delineated exclusive rights, the collective holders of a responsibility contract are, not surprisingly, prone to argue over the division of the income generated by their joint efforts.
>
> Second, virtually all productive assets other than land tend to have finite usable lives. Depreciation of equipment and buildings might be thought to justify the government laying down the amount of re-investment, the kind of goods to be produced, and the type of business that must be maintained. In deciding these matters, conflicts of interest arise between the government and the joint holders

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of responsibility contracts. Of course, there is simply no way the government could be expected, in a wide diversity of trades and industries, to rival the wisdom or expertise in decision-making of those actually engaged in the enterprise.

Third, the production process in trade and industry is generally far more complex than in agriculture. Contracting, sub-contracting, and sub-sub-contracting are common, and these have led to responsibility arrangements in complex, multi-stage forms. When the holders of an original responsibility contract—responsible directly to the government—sub-contract to others, the terms of performance and the division of income are difficult to negotiate because both the contractor and the sub-contractor lack the option of refusing to cooperate and of seeking competitive bidding elsewhere. Further, the government often wants to maintain a say over the terms of sub-contracting.

Fourth, because of changing market conditions, profits and losses fluctuate more sharply in trade and industry than in agriculture. Responsibility contracts therefore tend to have a much shorter life (typically one year). Holding to the labour theory of value, the government tends in renewing contracts to increase or reduce its "take" depending on the results of performance, and contractors who have performed above expectations naturally feel unjustly deprived of any reward.

Finally, productivity in trade and industry, far more than in agriculture, depends on the quality of human capital. An entrepreneur with creative ideas may be worth a fortune, but his innovation cannot be fully rewarded within the short duration of a responsibility contract. Indeed, a prime target for common condemnation of the responsibility system is the average wage ceiling of 250 RMB (about US$50) per month, imposed both to effect a desired distribution of income and to force an increase in investment.

I argued that to tackle these problems, three requirements are in order (Cheung 1986, p. 70):

> First, state ownership of depreciating productive assets must be relinquished, either to the highest bidder or simply as an endowment to members of the existing state enterprise. This must be done because these assets, or their values, unlike land, will disappear in time.
>
> Second, if several or many individuals own the assets, shares should be issued against the asset value and assigned to the individuals. If necessary, this division of wealth might be done by voting, as baseball players in the United States vote to divide the income from the World Series.
>
> Third, the shares must be freely transferable.

Of these recommendations, the only one the authorities remain reluctant to accept is the first, namely, relinquishing state ownership of depreciating assets. The impression I obtained at the time is that for

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political reasons state ownership of resources must be preserved. That is, private property may be practiced in nature, but not in name, and this dichotomy is far more easily resolved in agriculture than in trade and industry.

In September 1987, therefore, I suggested to my Beijing friends a new solution that, following Mao's terminology, may be called a "thorough" responsibility system. Thinking of a private individual borrowing from a bank to buy an automobile in the United States, in which the legal owner (the bank) and the registered owner (the individual) are separate, I proposed that the assets of a state enterprise be assessed and converted into a monetary value. The state would then "loan" this capital value to the individuals running the enterprise, with dues in the form of interest payments. The state would relinquish all controls as long as interest payments were met. With the issuance of transferable shares, the nature of private enterprise will be practiced while preserving the legal title of state ownership.

My proposal would have worked perfectly if the only concern were to preserve the image of a socialist system. There is no inherent conflict between the economic nature of private property and socialism. (After all, each individual is a social entity.) However, recent events suggest that the real problem of reform in trade and industry does not rest so much with the preservation of an image, or what the system should be called. Rather, the main problem lies in something most of us working on the theory of the state have known all along, namely, the protection of privileges associated with special rights. And it appears that special interests are far more easily defended in trade and industry than in agriculture.

Why Price and Wage Controls?

As early as 1981, I predicted that in China's movement toward private property, the last and most stubborn redoubt standing in the way of reform would consist of those state enterprises in which monopoly can be maintained most easily. This observation has become self-evident.

In agriculture and in household enterprises, competition is severe, and it is difficult for special interest groups to protect their rights. Similarly, in industries such as hotels, restaurants, or handicrafts in which entry is free, special rights dissipate readily with the onset of competition. A state-owned hotel surrounded by private hotels must follow what the market dictates or face defeat. The right to control is valueless if competitors are exempt from that control. In China there

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is no question that businesses subject to open competition have blossomed.

On the other hand, it is to be expected that sectors such as public transportation, public communication, utilities, petroleum, and mineral rights will not readily go private. But the list does not end there. Banking, foreign exchange, international trade, the steel industry, products with successful trademarks, and industries with trade secrets or with effective barriers to entry such as heavy machinery, drugs, and silk are all candidates for persistent state manipulation and control because of their monopoly status.

Authorities in charge of these monopolistic industries benefit from price and wage controls. From price control, the officials with the right to allocate or ration goods, along with those who have special rights to receive them, stand to gain at the expense of government subsidies as well as costs to consumers. From wage control, workers' income is reduced in favor of those in command.

While price and wage controls are easily enforced with state ownership, they are difficult in the case of private enterprise. For example, if fish is sold in a state-operated market in which profit and loss are not the concern of anybody, it can literally be marked at any price. But an individual who gets up before dawn, rides a bicycle to the village to buy a few fish with his own money, and then rushes back to sell in the market is likely to grow violent if a government official tries to restrict his pricing.

It is easy to give reasons for controls: wage control to promote a desirable income distribution; price control to check inflation, to assist the needy, to encourage industrial development, and so on. These justifications are both trite and wrong, but they are used routinely all the same. Even in our modern times, politicians seem to be running out of imagination.

The Chinese experience is the most telling. State ownership of monopolistic ventures is maintained because it is relatively easy to do so, and with state ownership, price and wage controls are relatively easy to enforce because no private party has a vested interest to object, and these controls generate income to individuals with special rights.

Supporting evidence is strong. Domestic plane tickets used to be sold at one-third the market price, allowing privileged officials to preempt blocks of them for sideways dealing. However, sometimes planes would fly almost empty. Steel for construction work is sold at less than half the market price, allowing those with the right to ration to capture handsome "rents." It is absurd that at a time when the whole of China requires rebuilding, the import of rebars is severely

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restricted. The foreign exchange rate (a price) is "controlled," so to speak, but special exchange centers are officially allowed to deal at near black market rates. That is, black market foreign exchange dealing is prohibited for private citizens, but not for government officials. The interest rate (again a price) is pegged at a level far below the rate of inflation. The result is that households or small state-owned enterprises cannot hope to borrow money, while officials with proper connections borrow to relend subtly, to invest carelessly, or to consume lavishly. And the list goes on.

A Collision at Last

We are all aware that proponents of market-oriented reforms in China have had their fair share of opposition. Yet with numerous reports of political infighting, China's progress has been so fast that it would have been unthinkable only a decade ago. We have felt all along that vested interests cannot be dismissed lightly, that there is no pay-off or buy-out which can be conveniently executed, and that a free-enterprise economy cannot be developed without bold actions. A reform program that benefits the society at large does not mean all its members will benefit. Some special interests, somewhere, somehow, will have to bear the cost of change.

On a number of occasions I have pointed out that China cannot remain long at this balance point without turning into another India. The Indian syndrome of government regulations, state-controlled monopolies, and massive corruption is certainly seen in China today. But unlike India, China's reform process has both mass and acceleration. A collision of reform and special interests therefore must come with great force at some point in time. From an optimistic point of view, it is a relief that this collision comes so soon. Yes, what China will turn out to be depends on what will happen in the next two or three years.

Observers concur on what they see. China has mounting and near runaway inflation; officials or state employees of ordinary status find their purchasing power declining with sticky wages. To print more money means more inflation. Yet inflation is apparently fueled less by increases in the money supply than by tight control of interest rates. With these rates being pegged significantly below the rate of inflation, people have a strong incentive not to hold renminbi (RMB). But to let the interest rate float would mean decontrol in a vital government monopoly.

As my whole argument implies, since price control exists primarily in state-owned monopolies, the freeing of prices would strip down

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the rights of the privileged groups. Furthermore, so long as enterprises are owned by the state, increased prices will not lead to increased production of goods and services as would be the case with private enterprise.

In 1988, Deng Xiaoping and Zhao Ziyang announced that it was essential for price controls to be bulldozed away. Their statement was bold and admirable. Some prices have since risen sharply, including those of liquor, cigarettes, and plane tickets. Unfortunately, the coverage does not extend to interest rates and exchange rates—which hints at powerful vested interests in these areas. It is equally regrettable that taxes, dues, and duties have also been increased. The great *sine qua non* now is to set right the fundamental source of the difficulties. China's deep and basic needs now are the privatization of state-owned enterprises and the demolition of state-created monopolies.

The Nature of the Problem

China has reached a point where piecemeal tactics are not likely to be effective in advancing her economic reforms. During the past decade such tactics have served China well, often brilliantly. While cadres and citizens alike agree that the "common rice wok" and the "iron rice bowl" are detrimental to productivity and must be discarded, they have little understanding of how a market system based on private property rights operates. With the Marxian doctrine nearly dead, there was, and still is, an ideological vacuum in China. The piecemeal approach thereby adopted is impressively pragmatic, using common sense rather than theory to correct the economic ills that have become all too evident. Indeed if any people can be called experts on the shortcomings of a communist system, the Chinese have no peers. Piecemeal tactics guided by common sense and the economic forces at work have, by and large, been the policy guideline for one decade. And in spite of the political opposition and occasional backslidings that have often occupied news headlines, progress has been phenomenal.

In the process, a substantial number of comrades have lost their privileged status. The more astute ones have turned to trade and industry and do well because of connections. Others have become ordinary citizens or have gone into retirement. In areas subject to intense competition, previous hierarchical rights based on rank regardless of productivity have become valueless. In other areas, however, these privileges are transformed into monopoly and regu-

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lation rights. An attempt to protect a state monopoly or to protect a regulation is an attempt to protect "a right."

I can cite numerous instances to support this view. But if we must single out one example of prime importance, then the financial sector would be a natural choice because of the wide ranging implications involved, and because its problems make the headlines almost every day.

Take Wenzhou for instance, where any impartial observer must stand in awe of its economic success. A number of small private savings-and-loan institutions cropped up to finance small businesses, with brilliant success. But this booming enterprise was soon restrained by the banking authority, which imposed interest and licensing regulations. Again, in the area of foreign exchange, it has been a monopoly long enjoyed by the Bank of China, reaping handsome profits through exchange controls and rationing. But when black market activity became prevalent and hard to control, the authorities themselves started exchange centers dealing in near free-market rates. It is difficult to say in what sense exchange control now exists in China. Certainly all arguments in favor of it have been flatly contradicted by the government's own behavior.

Indeed the pattern is replete that where competition is severe and monopoly power can hardly be maintained, the authorities routinely opt for a freer market and more private property protection. But where monopoly is protected, the policies adopted always tend to benefit special interest groups and, along with price and wage controls, the superiority of socialist ownership is again upheld as unquestionable.

Nothing can be further from the truth. The arguments for freer markets and for the necessity of maintaining controls, often heard from the same authorities, reveal such glaring contradictions that one must infer that the prime motivation of controls is to benefit privileged groups. There is no conceptual difference among the monopoly and controls in silk, steel, heavy machinery, foreign trade, foreign exchange, and banking. The problem is general, although inflation and the difficulty of feeding state employees (as well as students) are placed in the spotlight, they tend to obscure the nature of the problem.

Monopoly protects; state ownership facilitates controls; the right to control generates income to the privileged. This is as true in the production of goods and services as in the banking and financial sectors, although the latter has broader implications for the economy as a whole. The piecemeal tactic of decontrolling a few prices, of restraining the growth in money supply, or of curbing government expenditure does not get to the heart of the matter. A general problem

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calls for a general solution: Privatize state enterprises and allow free entry for all.

Conclusion

It is somewhat puzzling that the currently reported 25 to 30 percent annual increase in the money supply of RMB could have caused a near 30 percent annual rate of inflation. A number of localities in China have experienced real growth rates in excess of 25 percent per year, and goods and services that were previously self-consumed or bartered are now transacted in the marketplace. These things are not recorded in the official statistics. Still, one may argue that a 15 to 20 percent monetary growth per annum would be more appropriate. However, I surmise that the current inflation in China is prompted mainly by controls on interest rates, by government restrictions on savings-and-loans or small private banks, by the fact that even major foreign banks are not allowed to perform the essential functions of banking, and because output in state-operated enterprises are not elastic to increases in price.

The financial difficulties of China so often discerned are real. But how are these possible? How is it possible that a nation with citizens now rushing to buy gold has more financial problems than when they could not even afford to buy vegetables? Why should the Chinese government now find it necessary to impose heavy taxes on practically everything, as compared to the earlier starvation period when taxes were unheard of?

No, China should not have any financial problems at all. She has all the "lands under heaven" to sell, all the mineral rights to sell, numerous state enterprises to sell, and an army of officials who could be relieved and turned to more productive employment. If these things are done, China would have a budget surplus with a tax system as simple as that of Hong Kong, and even at lower tax rates.

More fundamentally, therefore, my view is that whereas the formation of private property via contracting has been relatively smooth in areas subject to active competition, the process fails when it comes to areas where monopolies are fostered. It is time for China to consider the creation of private property by mandate. And whereupon they may follow one simple rule: For state-owned resources that are salable, sell. This is the most straightforward way to create private property, and the selling prices as well as the forms of payments may be adjusted as special cases demand—in the initial sale to distribute and define property rights, the market price need not be applied. The proceeds may be used to compensate individuals who suffer

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greatly from the changes, to invest in the infrastructure (or better still, to loan out to private parties for such investment), and above all, to establish a judicial system based firmly on the principle of equality before the law.

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The Depoliticization of Economic Life in China

James A. Dorn

Steven Cheung has written a very interesting and thought-provoking paper. He sees the state monopoly of trade and industry, with its bureaucratic overhang, and the lack of an effective legal system as major barriers to China's continued economic development. The source of the so-called Chinese headache, according to Cheung, is the failure to depoliticize economic life—that is, to overcome powerful special interest groups who continue to oppose thoroughgoing price reform and the privatization of state enterprises. Not surprisingly, the Chinese puzzle is the same as that facing other socialist nations, namely, how to insulate economics from politics.

The Preservation of Privilege and Chaos

When ownership and control rights are lodged in state monopolies run by political operatives who are not subject to the profit/loss test of competitive markets, economic decisions necessarily become political decisions. The status quo then becomes the norm, and privilege, not competence, determines "who gets what." Such is the case in state-owned enterprises that dominate trade and industry in China.

A rule of law protecting persons and property is essential for a vibrant economic life. The lack of a sound legal system safeguarding property rights and freedom of contract has hampered the formation of competitive markets and prevented the emergence of a rational price system in China. The Chinese wall that surrounds the nomenklatura in trade and industry has prevented the free flow of information that is essential for economic harmony.

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By disallowing market forces from freely determining the movement of prices and the allocation of resources, political competition has overruled the impersonal competition of the market price system. And by disallowing private ownership of enterprise assets, the linkage between individual action and responsibility has been weakened. The vacuum left by the absence of the disciplinary force of bankruptcy, by the lack of transferable shares reflecting future value consequences of current resource usage, and by the fact that managers of state-owned enterprises have no exclusive right to residual income has been filled by a pervasive bureaucracy having vast economic empowerments. In such a system, political considerations inevitably clash with rational economic decisionmaking.

What has emerged is a welfare system for government monopolies—in which the costs of inefficient resource usage are socialized by an extensive system of subsidies—and a redistributive state writ large. By failing to separate the political and economic regimes, China has become a rent-seeking society in which national wealth is dissipated in a struggle for power and privilege. The disease affecting Western democracies, in which the rule of law has been eroded, is at epidemic proportions in China's state-controlled sector. To survive in a politicized economy means to cater to political preferences rather than to consumers' preferences. In such an environment, reform is difficult and corruption is a predictable trait of economic life.

When the Chinese nomenklatura stand to lose their privileged position as the economy is decentralized, they will present a formidable force against economic reform. As long as the economy is driven by politics, it is rational from the perspective of the ruling elite to retain rigid control over the use and disposition of enterprise assets. And as Cheung notes, it is also rational to set prices below market-clearing levels—since this tactic provides greater discretion for those in control to determine who gets what and allows them to enhance their personal wealth by buying low and selling high, either in the black market or in the open market if there is a two-tier pricing system.[1] Within China's closed society, the elite and their families and friends stand to benefit at the expense of the public at large. The much heralded equality under state ownership and socialism is therefore more of a myth than reality.

Examples of corruption within China's state-controlled sector abound and provide additional support for the hypothesis that managers of socialist enterprises can be expected to shirk more often than

[1]Cf. Alchian (1967, p. 13) who has argued that the attenuation of private property rights provides an incentive "to charge prices below market-clearing levels more frequently."

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managers of private for-profit firms.[2] Cheung points to cases in the airline industry, steel, and foreign trade where officials have used their "right to ration" for personal gain. In a similar vein, Julia Leung (1989, p. A12) observed that often the monies used to prop up inefficient state enterprises are wasted "on grandiose construction projects, inappropriate equipment, and fancy state housing" or find their way into the pockets of "corrupt officials." Again, the basic problem, writes Leung, is "the failure . . . to distance government from the running of enterprises."

Two other examples reinforce the corrupt nature of state ownership and control over economic life. Dorinda Elliott (1988, p. 42) calls attention to the practice by which "scalpers, called 'yellow cows' in Shanghai, buy up cheap state-subsidized goods direct from the factory—often by bribing the plant manager—then sell them at premium prices to consumers." And in a recent article in the *Far Eastern Economic Review,* Ellen Salem (1988, p. 22) observed that "the shortage of raw materials and the state monopoly on supply in certain instances all but force managers to bribe officials to get whatever they need." Thus, it is not surprising that a recent survey by the Chinese Academy of Social Sciences (CASS) found that 83 percent of China's urban population believe China's nomenklatura engage in corrupt practices. What is surprising, at least from a Westerner's viewpoint, is that the same survey found that 63 percent of the nomenklatura admitted they were corrupt.[3]

Typically, those who oppose economic reform lay the blame for widespread corruption on the liberalization of markets and prices rather than on the government's failure to depoliticize economic life by divesting the nomenklatura of their control over enterprise assets. Thus, in trying to discredit the economic reforms, Radio Shanxi used the market system as a straw man, arguing that corrupt practices were the result of "the corrosive influences of the decadent capitalist ideology."[4]

[2]For a survey of some of the relevant literature on managerial behavior in socialist enterprises, see Furubotn and Pejovich (1972, pp. 1154–57). The key point is that the absence of capitalization and residual claimancy in state-owned enterprises means that socialist managers will have less incentive to engage in profit-maximizing behavior than managers of private for-profit firms. The rewards for efficient behavior in socialist firms are narrowly limited and the probability of failure is dampened by state subsidies. On the other hand, as Alchian (1967, p. 12) has emphasized, the "marketability" of shares in private firms "implies *capitalisation* of future effects on to present values. Thus, long-range effects are thrust back on to the current owner of the marketable value of the goods." As such, private owners "will heed the long-run effects of current decisions more carefully than if the rights were not transferable."

[3]The survey results are reported in Salem (1988, p. 22).

[4]Quoted in Salem (1988, p. 22).

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The locus of failure, however, lies with the state not the market. As Cheung and others have recognized, it is the state's monopoly over trade and industry, the piecemeal approach to price reform, and the absence of private property and freedom of contract that are the fracture points in China's economic landscape. As long as the state holds most of the economic empowerments—so that special rights and privileges are extended to the nomenklatura—corruption will continue.

Moreover, as long as the state controls the bulk of economic resources and supports inefficient enterprises, the incentive to finance the deficits of state-owned enterprises directly through bank credits will remain a threat to China's social and economic stability. The current inflation rate, estimated at more than 20 percent per annum, has already given cause for slowing ownership and price reform. Without monetary stability, more secure property rights, and free-market prices, it will be impossible for China to realize its full potential for economic and social development.

The vesting of ownership and control rights in the state bureaucracy has prevented real markets from developing in a large part of the Chinese economy. It is the lack of constitutional constraints on government and the absence of a private property framework for markets and prices that concern Cheung. In the absence of a constitutional anchor holding the state at bay and a competitive price system rooted in effective private ownership, vested interests will remain in power. The anticipated result will be corruption and chaos. Thus, until the depoliticization of economic life occurs, the spontaneous market order that has been the characteristic feature of open competition and private property will fail to appear in China.

In sum, the absence of a sharp delineation between political life and economic life in China has led to a privileged class that has the power to control economic levers. The persistence of the Chinese nomenklatura in trade and industry has slowed economic reform, led to inconsistent prices, and increased uncertainty. The current chaos in China's economic life, therefore, is due in large part to the nomenklatura's refusal to extend private ownership and competitive pricing to trade and industrial enterprises where state monopolies prevail. More fundamentally, it is the refusal of those in power to insulate economics from politics that lies at the heart of China's difficulties. As Hua Sheng and two other economists from the CASS recently noted, the current corruption and inflation in China can be traced to the "failure to separate political power from economic management." In their opinion, "The Chinese economy today is, to a significant

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extent, manipulated by political power."[5] To free trade and industry from the inefficiency and disorder associated with the present regime, Cheung proposes radical institutional reform.

The Privatization of Trade and Industry

The Chinese wall surrounding the nomenklatura must be broken if trade and industry are to be freed from the fetters imposed by the privileged class. For Cheung, piecemeal tactics will not work, neither will the extension of the so-called contracting system to state monopolies. What worked so well in agriculture will not work in trade and industry because of the entrenched bureaucracy and lack of competition, argues Cheung. "China's deep and basic needs now," writes Cheung, "are the privatization of state-owned enterprises and the demolition of state-created monopolies."[6] Only in this way can China's economy open to the competitive forces that will ensure its long-run survival in an increasingly interdependent world economy.

Thus, although Cheung previously advocated an indirect approach to creating effective ownership in state enterprises, he now calls for a more direct approach. In particular, he argues that "It is time for China to consider the creation of private property by mandate." To do so, he proposes a simple and straightforward rule: "For state-owned resources that are salable, sell."

Cheung's privatization scheme is meant to crack the back of the nomenklatura and to open trade and industry to the forces of the marketplace. For once property is in private hands, incentives will operate to drive out inefficient producers and reward those who satisfy market demands at competitive prices. When the government is no longer an intermediary in most economic transactions, buyers and sellers will find it easier to arrange mutually beneficial exchanges without the added cost of bribing public officials and the uncertainty of bureaucratic discretion.

The exact terms of each sale of government property are less important to Cheung than privatizing state-owned enterprises as quickly

[5]Hua Sheng, Zhang Xuejun, and Luo Xiaopeng as quoted in "China Reforms Said Snarled by Politics" (1989, p. A9).

[6]Cf. Hua, Zhang, and Luo who have argued that the only way to end the corrupt practices associated with the state's monopoly over the material supply system and to ensure the success of China's market-oriented reform is to strip state officials of their monopoly power. Referring to the nomenklatura who control the state supply system, Hua and his colleagues argue: "They have shown no scruples about illegal speculation or taking bribes" and "must be stripped of their monopoly." Like Cheung, these economists believe that "a genuinely market-oriented reform requires the state to cede its power and responsibility in almost all economic fields." Quoted in "China Reforms" (1989, p. A9).

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as possible in order to deprive the nomenklatura of their special rights and privileges. Moreover, Cheung suggests that part of the proceeds from privatization be used to help compensate those individuals who are significantly harmed by the institutional change. Such a strategy could help ease the transition process by breaking down some of the resistence to privatization. The main point, however, is that the divestiture must take place by mandate; otherwise it will not occur because of the strong resistance by special interests.

If China's leaders really want to achieve thoroughgoing reform, they will have to recognize two basic ideas that Warren Nutter (1968, p. 144) so aptly expressed: (1) "Markets without divisible and transferable property rights are a sheer illusion"; and (2) "There can be no competitive behavior, real or simulated, without dispersed power and responsibility." Learning to appreciate these facts may help point the way toward the type of reform Cheung is now advocating.

The inconsistency of the current reform measures can be removed only by taking the general approach recommended by Cheung. Only by radical institutional change—privatizing state-owned enterprises and breaking the back of state monopolies—can the vested interests in China be demobilized and the framework set for an internally consistent price mechanism that will guide resources to their highest-valued uses without state intervention. To foster this process, Cheung also proposes using the proceeds from privatization "to establish a judicial system based firmly on the principle of equality before the law."

A Constitution of Liberty and Spontaneous Order

Solving the Chinese puzzle of insulating economics from politics requires, in the words of F. A. Hayek (1960), a "constitution of liberty." By allowing greater economic and personal freedom, and safeguarding them by a sound constitutional framework, China can limit the rent seeking and corruption that have undermined social and economic stability. Furthermore, a constitution protecting private property and freedom of contract will establish the institutional basis for the emergence of a spontaneous market order.[7] Unless China's leaders institute effective constitutional constraints on the power and scope of government, the redistributive state will prevail and the benefits of an open-market order will be lost.

A constitution protecting the rights of persons and property, along with a strong judiciary to guard these rights against political oppor-

[7]On the importance of a constitution of liberty for the emergence of a spontaneous market order, see Hayek (1960, 1982).

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tunism and special interests, is essential for the maintenance of a free and prosperous society.[8] By increasing the security of persons, property, and contracts, a nation's wealth will immediately increase, even without any corresponding increase in physical resources or technology. In the long run, the greater security of private rights—both economic and personal—will encourage new investment and foster economic growth. This is why Cheung is so insistent on improving the legal and judicial system in China.[9]

China's leaders recognize the need for a sound legal system if economic reform is to succeed. At the Thirteenth National Congress of the Communist Party, Zhao Ziyang (1987, pp. 58–59), for example, called for "strengthening the socialist legal system" as a way to "guarantee against a recurrence of the 'cultural revolution' and for lasting political stability." He also argued that China should "give play to market forces and free competition" (p. 25) and undertake institutional change "to promote the development of a market system" (p. 36). Meanwhile, Deng Xiaoping (1987, pp. 147–48) observed: "The reform of the political structure and the reform of the economic structure are interdependent and should be co-ordinated. Without political reform, economic reform cannot succeed."

The question then becomes, what type of political reform is consistent with China's market-oriented economic reform? Deng's dictum that "In everything we do we proceed from reality" (1987, p. 177) is an insufficient guide for constitutional change. What is necessary is that Deng and his colleagues acquire an understanding of constitutional and economic *theory*, in light of historical evidence, so that their trial-and-error method can be improved upon. The lack of an overall constitutional perspective—and the failure to understand the relation between private property rights protected by law and the emergence of open markets and competitive prices that coordinate economic activity without central direction—hamper economic liberalization in China. Indeed, according to Cheung, there is "an ideological vacuum in China," with "little understanding of how a market system based on private property rights operates."

Although the Hayekian knowledge problem is generally recognized as a fundamental flaw of central planning, the concept of spontaneous order is still foreign to most of China's leaders who were

[8]For a discussion of the significance of stable property rights and a sound legal system for minimizing rent seeking and promoting economic growth, see North (1987).

[9]Cheung (1986, p. 25) has argued: "The Chinese Constitution, rather than establishing a structure of rights for social and economic interaction, merely serves to confuse. If . . . economic progress depends on constitutional law, China's plans for modernisation would undoubtedly be best advanced by a total rewriting of the country's Constitution."

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brought up on Marxian economics and the superiority of central planning, without which the economy is thought to be in a state of chaos.[10] Nevertheless, Deng and other leaders have been impressed (and surprised) by the resiliency of the market and the spontaneous emergence of thousands of small-scale enterprises that followed in the wake of the agricultural reforms. According to Deng (1987, p. 189):

> Our greatest success—and it is one we had by no means anticipated—has been the emergence of a large number of enterprises run by villages and townships. They were like a new force that just came into being spontaneously. . . . If the Central Committee made any contribution in this respect, it was only by laying down the correct policy of invigorating the domestic economy. The fact that this policy has had such a favourable result shows that we made a good decision. But this result was not anything that I or any of the other comrades had foreseen; it just came out of the blue.

The lesson is simple: Individual self-interest will promote the nation's wealth, as Adam Smith envisioned, once the appropriate institutions are in place, whether in Hong Kong or the People's Republic. Foremost among these institutions is an economic constitution that safeguards property and maintains a sound monetary and fiscal regime within which rational economic calculation can proceed.

Deng's willingness to experiment with ownership and price reform has been beneficial. Yet, his quest for improving China's standard of living would be advanced more rapidly if he and his colleagues had an understanding of what James Buchanan (1979, pp. 81–82) calls the "most important central principle in economics," namely, "the principle of spontaneous order" (or "the spontaneous coordination which the market achieves"), and if they recognized that this order critically depends on a constitution of liberty. In this sense, then, the problem of economic reform in China is a problem of constitutional economics, that is, a problem of how to change the rules of the game—the effective economic constitution—to increase freedom and wealth.

In thinking about constitutional change, China's leaders can look both to the West and to their own cultural heritage. In the West, they can draw on the work of classical liberals who first conceived of the market as a spontaneous order; they can learn from the work of James Madison concerning the dangers of unlimited democracy and the importance of constitutional constraints on majoritarianism; and they

[10]See Hayek ([1945] 1948) for a discussion of the information and incentive functions of prices and profits in solving society's economic problem—"a problem of the utilization of knowledge which is not given to anyone in its totality" (p. 78).

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can benefit from recent developments in public choice theory, property rights theory, constitutional economics, and the new institutional economics. From their own cultural background, they can gain a greater appreciation of the proper role of government, the chaos created by unlimited government, and the importance of individual freedom in fostering responsible action and spontaneous order.

Both Confucius and Lao Tzu taught that the state should be subservient to the individual and that the best state is the one in which the ruler does not interfere with the natural order, which would emerge spontaneously if individuals followed the principle of noninterference. As Wing-Tsit Chan (1969, pp. 136–37) notes:

> In its doctrines on government, on cultivating and preserving life, and on handling things, Taoism is fully the equal of Confucianism. . . . It teaches submission, but strongly opposes oppressive government. The philosophy of the *Lao Tzu* is not for the hermit, but for the sage-ruler, who does not desert the world but rules it with noninterference. Taoism is therefore not a philosophy of withdrawal. Man is to follow Nature but in doing so he is not eliminated; instead, his nature is fulfilled.

The importance of China's cultural background as the basis for guiding modern-day constitutional reform and economic development is further illustrated by the following passages from the *Lao Tzu* or *Tao Te Ching:*

> Govern the state with correctness. . . . Administer the empire by engaging in no activity. . . . The more taboos and prohibitions there are in the world, the poorer the people will be. . . . The more laws and orders are made prominent, the more thieves and robbers there will be. . . . Therefore the sage says: I take no action and the people of themselves are transformed. . . . I engage in no activity and the people of themselves become prosperous.[11]

These ideas reappeared centuries later in the works of Adam Smith and his contemporaries, and in the discussions shaping the U.S. Constitution. It is to this body of thought and to their own cultural heritage that China's leaders can now turn to find a sound basis for their pragmatic reforms. Armed with the logic of constitutional choice and the logic of the price system, China can move forward into the 21st century confident of its place in the world economy. Once the institutional basis is laid for a stable government by law, order will replace chaos and the open market will allow the creative energy of the Chinese people to be released for their own good and that of the world economy. This is Cheung's hope and it is mine as well.

[11]*Quoted in Chan (1969, pp. 166–67).*

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Establishing a New Order of the Socialist Commodity Economy

Xu Pengfei

Professor Cheung has freely and candidly described and analyzed the situations, controversies, and contingencies of our economic reform. In the old days the rigid economic mechanism had pulled the leg of our productivity. That is why reform is needed. Our ultimate aim is to build socialism with Chinese characteristics, in conformity with which we are to decide what reforms should be carried out and where they should lead to. We need to learn from the experience of other countries, but not necessarily follow their footsteps.

Price Reform and Wage Reform

China's present economic situation is far better than anybody could imagine 10 years ago. Such indexes as the total output value of the entire society, the total industrial and agricultural output value, and national income are shooting up by dazzling percentages. Statistics show that the actual take-home pay of the peasants and the city dwellers, even though we incorporate the inflation rate, is steadily increasing from year to year. All enterprises, with Party guidance separated from management, are rapidly becoming independent commodity producers and operators. It must also be pointed out that although over recent years a "double-track system" combining the mechanisms of a planned economy and a market economy has been initially introduced, this combination has not attained perfection either in terms of theory or practice. The new order of the socialist commodity economy has to evolve from a highly centralized old order that excludes market mechanisms. Therefore, the establishment of a new economic order in China is a painful and relatively long process. At present, China is in the midst of a transitional period during which

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the new and old systems are interwoven with the new replacing the old step by step. In particular, there now exist two systems, two price structures, two social psychologies, and both positive and negative factors typical of the initial period of growth of a commodity economy. The direct results of this kind of coexistence have been dwelled upon by Cheung. China's economic reform is an unprecedented undertaking for which various blueprints can be drafted. But whatever blueprint is drafted must conform to the actual conditions of China. What, then, is the way out for China?

The 10th Plenary Session of the Central Political Bureau of the Communist Party of China held in mid-August pointed out that the crux of the economic reform lies in price and wage reform. Undoubtedly, this is a timely, wise decision based on previous practice and suggestions by economists both at home and abroad. According to this decision, while the prices of several major commodities and the cost of labor are to remain regulated by the state, the prices of the majority of commodities will be decontrolled and subjected to the adjustments of a fluctuating market. Fluctuating prices will then form a system of their own, leading step by step to the goal that "the State adjusts and controls the market which, in turn, leads and guides the enterprises." The immediate objective for the next five years or so is to gradually systemize more reasonable price relations and solve those problems seriously affecting economic expansion and market growth. The overall aim of the wage reform is to ensure no drop in the actual living standards of the majority of working citizens by wage adjustments and hikes plus necessary allowances and, furthermore, to help improve living standards alongside the development of production. Meanwhile, the principle of distribution according to work will be further put into practice, to solve the problem of unfairness in distribution.

The basic direction in which China's economic reform is going is to establish a hitherto unknown new order of the socialist commodity economy. In other words, we aim at a macro-market appropriately guided by state plans. The core issue is prices. Therefore, if we succeed in the price reform, we can achieve a breakthrough that serves to coordinate the relations of the state, the enterprise, and the individual by well-regulated price and market mechanisms. This is a highly complex undertaking; many things remain to be experimented and theoretically crystallized.

Reform in the Ownership of Enterprises

The pivotal task for China's economic reform is to reform the system of management and administration of our enterprises so as to

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tap vitality and increase the economic effectiveness of production and management. China's economic reform began with a reform of the responsibility system in the rural areas. Reforms in urban areas are much more complicated, bearing upon many fields of economic endeavor such as production, circulation, finance, and taxation. To increase economic effectiveness, it is imperative to introduce a new and well-coordinated market mechanism and price system, that is, to completely decontrol market prices that were kept down when the planned economy held sway. Prices will then fluctuate according to the law of supply and demand, going up more than down of course. This is exactly what we witness today.

The living standards of Chinese consumers will be raised rather than lowered if three conditions hold: (1) The increase in prices of the means of production is absorbed by the enterprises themselves, which seek to improve management; (2) the wage reform is conducted with a view to relative balance among different walks of life; and (3) actual income is increased along with necessary state allowances.

Our current concern is that in the chain of circulation dubious activities of profiteering take place. We are pleased to see the Chinese government has taken due notice of such economic crimes as bribery, embezzlement, and hands-changing speculation and is clamping down on them according to the law. Apart from punitive measures to combat such activities, what is more important is to help the officials and the people to see that everybody's welfare lies in the well-being of the nation, and therefore we need to forge ahead and surmount all obstacles.

Let me repeat, the question of fundamental importance is to improve the economic effectiveness of the enterprises. It is no good dreaming about increased economic effectiveness while relying on the existing enterprise system of operation. Reform of the existing ownership system is of special importance to the large- and medium-sized state-owned enterprises, since they play such a vital role in the national economy.

Practice has proved that management responsibility by contract is a useful approach whereby the internal structure of the enterprise is made to function more effectively. We are trying to deepen, perfect, and develop an all-round management reform centered on management responsibility by contract so as to make all our enterprises independent operators responsible for their own profit or loss. Reform in the ownership and management systems takes a variety of forms. We need to try out various forms and keep perfecting such forms so

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that we can decide on the best one through comparison; we do not encourage compulsory uniformity in this respect.

I feel obliged to add that the structural reform of large- and medium-sized state-owned enterprises involves very sophisticated system engineering. Whether an enterprise is owned by the state or owned collectively is not subject to change and must not change. But privately owned enterprises can be allowed to exist alongside.

How do we improve the efficiency of the enterprises with the ownership ultimately in the hands of the state? Brought under public notice for the past few years are such means as responsibility by contract, rent and lease arrangements, and shareholding. The key link in enterprise reform is to help activate truly talented and capable persons who are given a free hand in matters concerning management while being held responsible to a reasonable extent economically. To do so, some reform in personnel management is likewise called for.

Legal Guarantee and Promotion of Economic Reform

China's reform process is to be further deepened. Synthesizing the experience of other countries, we realize that China is now confronted with a problem of how to institutionalize (especially by legal means) the experience she has so far accumulated and the patterns of reasonable development. Economic lawmaking is a matter of special cogency in establishing a new order of the commodity economy. "The Law on Joint Venture Using Chinese and Foreign Investment." China's first law to govern international economic activities, took only six months to make in 1979. Since then, over 20 laws of this kind, over 100 acts regarding international economic activities, and over 200 regulations concerning export-import departments have been instituted. The body of these laws, rules, and regulations have vigorously promoted the expansion and growth of economic and technological cooperation between China and other countries. "The Patent Law," which was passed in 1984 and put into effect on April 30, 1985, has stimulated a flood of patent applications that now number over 68,900 in all with 18,000 for the 1985–86 period. "The Bankruptcy Law" has put an end to the practice of using such executive punitive measures as closing up, suspending production, or merging and changing the lines of products. It has ushered in a highly selective mechanism of competition, and given rise to a sense of crises on the part of the managers who would then spare no efforts to improve management and economic effectiveness.

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To date, the legislative bodies at the central and local levels have combined to bring forth a large number of laws, rules, and regulations among which are "The Law of Economic Contracts" (1982), "The General Rules of Civil Law" (1987), and "The Enterprise Law of State Ownership" (1988), to name only a few. There are other laws and regulations governing economic conglomeration, taxation, finance, and land control. Such lawmaking is an indispensable part of economic reform, although there remain measures to be taken to substantiate it.

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Economic Chaos or Spontaneous Order? Implications for Political Economy of the New View of Science

Don Lavoie

Introduction

Ideas about political economy, like other products of human culture, are liable to being profoundly influenced by underlying conceptions of the nature of science. Socialist political economy was not just influenced by the 19th-century view of science, it was modeled on it. Marxism has been widely interpreted as a "scientific socialism" in a strictly Newtonian sense, a study of the "laws of motion of the capitalist system" analogous to the physical laws of motion of planetary systems. I will later take up the question of whether this is the best way to read the essential message of Marx, but in any case it would certainly be understandable if many aspects of the Marxian system of thought were tainted by the mechanistic model of the universe in which 19th-century culture was embedded. The great successes of Newtonian mechanics made them a natural object at that time for emulation in the study of human society. But other, non-Newtonian, sciences have by now been successful too. Even thermodynamics and organic chemistry exhibit features that do not fit well in the mechanistic Newtonian view of the universe, and if we consider biology, anthropology, intellectual history, or psychology, we find fields that have made enormous accomplishments over the past century without coming close to the Newtonian model. The argument from success no longer makes a good case for the mechanistic view of the world.

There is now a wide body of explicit philosophical literature that, for want of a better label, I will simply call the new view of science,

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which develops a way of coming to terms with the nonmechanistic nature of the universe.[1] This literature constitutes, among other things, a radical reinterpretation of the nature of order, and a powerful critique of the Newtonian vision. It carries important implications for a variety of scholarly disciplines, from mathematics to the natural and social sciences, to the humanities, and it has begun to serve as an inspiration for practical proposals in everyday life.

In the contemporary work on "chaos theory" in mathematics, things that would appear to be utterly disorderly by Newtonian standards are seen to nevertheless possess great intelligibility, even mathematical elegance and beauty. The theory is misleadingly named because what is being celebrated here is not really utter disorder but a new kind of order. Scientists have found applications of these ideas in a remarkably wide range of phenomena that exhibit what Erich Jantsch (1980) calls a "self-organizing" process and Ilya Prigogine and Isabelle Stengers (1984) call "order out of chaos." Michael Polanyi, a physical chemist and philosopher of science, coined the phrase "spontaneous order" to describe this kind of process, and he has elaborated on how scientific discovery is itself a spontaneous order. Friedrich A. Hayek, an economist and social theorist, has elaborated on this idea in reference to the ordering processes at work in law and the economy.

One thing all of these spontaneous order theorists have in common is an emphasis on the creative aspect of ordering processes. The processes are not merely "equilibrating" in the Newtonian sense, where there is a deducible "target" toward which forces are pulling. An equilibrating mechanism, like a clock winding down, contains from the outset everything necessary to bring about its conclusion. A spontaneous order exhibits essentially novel changes and needs to work itself out through time. The direction things take may be completely unpredictable, and yet an overall pattern emerges and is systematically discernible.

Just as 19th-century socialists constructed a radical vision based on that century's view of science, so the economic reformers in the People's Republic of China are taking the views of science of our own time as their starting point. The philosophers who seem to have been serving as the inspiration for these reformers, such as Nobel Prize winning physicist Ilya Prigogine, are some of the most articulate spokesmen for the new view of science. The Chinese reformers have already been using this new view of science to revise their interpretation of socialism into a more humanistic and decentralized

[1]For a useful summary of the new view of science, see Gleick (1987).

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vision. In this paper I will be endorsing the humanistic revision of socialism and elaborating on how I think one of the classic critiques of orthodox socialism is consistent with the new view of science. The older views of socialism, I will be arguing, have been subjected to criticisms along essentially the same lines as the older views of science have been. These criticisms suggest that all the world's governments, whether called socialistic or capitalistic, have been trying to centrally control their economies in a manner that is utterly futile.

Beyond Traditionalism and Modernism

> Do we really have to make this tragic choice? Must we choose between a science that leads to alienation and an anti-scientific metaphysical view of nature? We think such a choice is no longer necessary, since the changes that science is undergoing today lead to a radically new situation. This recent evolution of science gives us a unique opportunity to reconsider its position in culture in general. Modern science originated in the specific context of the European seventeenth century. We are now approaching the end of the twentieth century, and it seems some more *universal message* is carried by science, a message that concerns the interaction of man and nature as well as of man with man.
>
> —Prigogine and Stengers (1984, p. 7)

The orthodox view of science that is sometimes called "modernism" arose in reaction to pre-scientific attitudes called "traditionalism." Traditionalism holds truth to be timeless and discoverable through revelation and by the dogmatic interpretation of sacred texts. It bestows unquestioned authority on a priestly caste, who act as a political elite as well as guardians of social mores. Within this world view, political economy is taken to be largely outside the domain of human choice, the product of supernatural forces guided by the gods. The order we find in the natural world is also intelligible as the conscious design of its creator, within this perspective, so that there is no great chasm separating the study of man from the study of nature. Both can be understood as teleological, as a matter of reading a text. We can read god's purposes in natural events just as we can read them (or perhaps a combination of man's and god's purposes) in human history.

Modernism is a useful label to tag the pro-scientific world view that arose against traditionalism because, to use the words of Donald McCloskey (1985, p. 5), it helps "to emphasize its pervasiveness in modern thinking well beyond science." According to McCloskey:

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> [I]n a preliminary way [modernism] can be said to be, as the literary critic Wayne Booth has put it, the notion that we know only what we cannot doubt and cannot really know what we can merely assent to. It is the attitude that the only real knowledge is, in common parlance, "scientific," that is, knowledge tested by certain kinds of rigorous scepticism. Philosophically speaking, modernism is the program of Descartes, regnant in philosophy since the seventeenth century, to build knowledge on a foundation of radical doubt.

The enlightenment represented a major break with traditionalist thinking and led to a radically different view of nature, man, and their relationship to one another. It opened the way for science, which in turn liberated many people from some of the constraints of traditional society. The astonishing successes of science, especially Newtonian physics, led to a momentous transformation of modern thinking. Nature is seen to be the outgrowth of predictable laws that are not the design of any conscious entity, but in principle are subject to human mastery. Natural forces are like mechanisms we invent, so that to the extent we comprehend their systematic elements we can expect to subject them to our purposes. Political economy too can be rendered as a systematic mechanism that can be mastered if we only learn its principles of operation. A central part of the enlightenment was the undermining of established authority and its claims to dogmatic access to the truth. The fruit of this challenge to traditional authority was a new defense of the independence and autonomy of individual human beings, and the realization of greater freedom through the bourgeois revolutions. Society was to be modeled after science in the sense that it was to be universal principles, discoverable by a systematic study of political economy, that would rule, rather than the arbitrary desires of traditional authorities. The rights of man were declared inviolate, just as the laws of nature were. The rulers were to be as much subject to the principles of freedom as their "subjects." The creative powers of free minds have now been unleashed on the world. We find ourselves trying to cope with changes in our everyday lives more rapid than any period in human history. The rise of the enlightenment gives birth to the "modern" world with its dizzying array of new technologies. And of course all this change has given us an accompanying set of new problems.

The enlightenment has led to great advances, but it can also be seen to have led to some shocking catastrophes. The attitude of "modernism" that it spawned leaves a dangerous gulf between our everyday understanding of the humanly meaningful world around us, and our scientific developments. This has had the inevitable consequence that as science advances our society becomes increas-

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ingly dehumanized. Within the modernist world view there is no way to make a rational case for any sorts of "rights," and political policy is thus reduced to a problem of social engineering, of using the population as resources for scientific planning. The very gains made by the enlightenment over traditional society, involving respect for the freedom and autonomy of the individual, are now seriously undermined by the philosophical prejudices of modernism.

The gains secured by the enlightenment cannot be simply reversed. Conservative philosophies that essentially wish we could return to the more fixed world of traditional society are still with us, but they are hopelessly utopian. There is no turning back to the (supposedly noble) days when every person was in his place and when we were content to leave our fate to the gods. We cannot address the new problems we face in the modernist age by reversing the great transformations that got us here. We cannot "forget" what we have learned in the advancement of science, nor can we expect people who have tasted freedom to go back to blind obedience to traditional authority.

The new view of science may help us to find a way to retain our modern society's respect for scientific progress without sacrificing our respect for the rights of individual human beings. It may help us to escape from the anti-humanistic attitudes of modernism without reverting to the anti-scientific attitudes of traditionalism.

Time, Complexity, and Humanity in Science

> The ambition of Newtonian science was to present a vision of nature that would be universal, deterministic, and objective inasmuch as it contains no reference to the observer, complete inasmuch as it attains a level of description that escapes the clutches of time.
>
> —Prigogine and Stengers (1984, p. 213)

Modernism can be summarized by reference to the way it deals with time and complexity, and the way it fails altogether to deal with humanity, in its conception of science. Time is reduced to a fourth dimension, fully analogous to spatial dimensions, and thus loses an aspect that, in our everyday experience, seems essential to it: its irreversibility. Complexity is treated not as an inherent feature of the world but as a temporary problem of our insufficient knowledge, to be overcome by reductionist methods. Humanity is to be either kept outside the scientific process as if it were a source of contamination, or reinterpreted so that it too is a timeless and ultimately simple mechanism. Each of these concepts would, if it were taken seriously, pose a challenge to the universality of the modernist world view, and thus each is diminished and transformed by modernism into a pale imitation of what we mean by it in everyday life.

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Modernism would like us to believe that it is merely our pre-scientific illusion that time is irreducible to space, that complexity is irreducible to simple and controllable causes, and that humanity is irreducible to mechanism. Thus it forces on us a dangerous dichotomy between science and life. Nature appears to be a timeless mechanism entirely foreign to our human experience of the world as "in time." It is supposed to be comprehended by reducing it to more basic and simple forces, by dissecting it into its elementary parts, whereas our human world seems only explicable in terms of complex wholes. Everyday experience and the humanities, which take that experience as real, are both "scientifically suspect" in the modernist culture. And it works the other way too: Many outside the scientific community find science itself "humanistically suspect." The much lamented split of our society into two deeply separated cultures is the result of a particular view of science.

The point of the new view of science is precisely to show that modernism does not only fail to do justice to everyday life and the humanities; it fails to do justice to most of the natural sciences themselves. Except for certain parts of classical mechanics, most of science today constitutes a challenge to the modernist view. Little of the natural world exhibits the kind of pure deterministic mechanism to which modernism sought to reduce everything. Even in physics, indeed in the very heart of physics, we find irreversible processes that defy the modernist view of time and complexity. Thermodynamics and physical chemistry are filled with processes that are irreducible to simple elements and relationships and are in principle irreversible in time.[2] And the impossibility of removing the observing subject from the scientific study of objects has been reinforced from within quantum mechanics by the work of Heisenberg. One does not have to be an anti-scientific metaphysician to question modernism.

As one moves up what we might call the scale of complexity from those simple phenomena that are amenable to Newtonian modeling through the more complex physical sciences and into the sciences of life, we find a greater and greater scope for nonmechanistic ordering processes, that is, processes that are intelligible but not predictable.[3] These processes take place in time as irreversible changes so that the question "When did it happen?" is not optional but central to

[2]See Polanyi (1958) and Prigogine and Stengers (1984).

[3]There is a long scholarly tradition of defending the human sciences against encroachment by the modernist view of science, but this methodological-dualist position concedes too much to modernism with respect to the natural sciences. On the idea that the differences between the natural and human sciences are of degree rather than of kind, see Polanyi (1959) and Hayek (1955, 1964).

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understanding what it was that happened. Such complex processes can be understood not in the sense that they can be simulated by simple models, but in the sense that they can be explained as resulting from general principles that have been found to govern this kind of process. We cannot deterministically model the biological process by which the human brain evolved, for example, nor can we predict where evolution will take us in the future, yet I think it is fair to say that we understand a great deal about this evolutionary process. And of course the place of man within science changes too as we move closer along the evolutionary path to the higher forms of living intelligence, and ultimately to ourselves, perhaps the most complex things we find in nature. The new perspective on science finds all the sciences and humanities on a continuum, all involving time, complexity, and humanity, varying only in degree, not in kind.

One of the great controversies of philosophy at the turn of the century was over whether the historical and human sciences are philosophically legitimate in light of the (then) obvious fact that they bear so little resemblance to the methods of the natural sciences. The procedure of simply telling a plausible story that fits the evidence seemed inadequate to give historical research scientific legitimacy. Today the tables have turned. The irreducible complexity and irreversible processes of history and the room history gives to the human subject no longer make history scientifically suspect. In short, the change from modernism to the new views on science is the change from the "scientization" of human beings to the humanization of science.

Mechanism and Order; Control and Cultivation

> Even if we cannot control the external circumstances at all, we may adapt our actions to them. And sometimes, though we may not be able to bring about the particular results we would like, knowledge of the principle of the thing will enable us to make circumstances more favorable to the kinds of events we desire. . . . An explanation of the principle will thus often enable us to create such favorable circumstances even if it does not allow us to control the outcome. Such activities in which we are guided by a knowledge merely of the principle of the thing should perhaps better be described by the term *cultivation* than by the familiar term "control"—cultivation in the sense in which the farmer or gardener cultivates his plants, where he knows and can control only some of the determining circumstances, and in which the wise legislator or statesman will probably attempt to cultivate rather than to control the forces of the social process.
>
> —F. A. Hayek ([1955] 1967, p. 19)

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If what was orderly about the world was only that in it which was pure mechanism, essentially timeless and simple, it would make sense to confine science to the search for strict Newtonian predictability. Anything, however complex, that we could not reduce to a fixed mechanism, to an underlying simplicity, we would sensibly label chaotic. Either something is "known" in the sense that it can be deterministically modeled as a predictable system like the orbiting planets, or it is unknown. The new view of science liberates us from this situation. Things that would appear chaotic to the modernist seem quite orderly to the proponents of the new view of science.

As Polanyi's work on science as a spontaneous order shows, the modernist conception of the nature of knowledge is fundamentally flawed. Modernism treats the process of science as if it were a matter of an isolated mind confronting and mastering the natural world. A single scientist follows given methods to bring nature under his rational control. The new view of science urges instead that it is the *dialogue* taking place in the scientific community as a whole which is the proper locus of analysis for the philosophy of science. It is the uncontrolled "dialogical" process that brings knowledge to the participants, not the strictly controlled "monological" methods of any particular scientist.[4] The process of mutual interpretations and criticisms going on in the scientific community is a good example of an order that emerges out of an apparently haphazard chaos. The process works best precisely when it is *not* under any one mind's control but is allowed to evolve by its own logic, taking advantage of the variety of perspectives it contains. A healthy scientific community cannot be designed in detail, it can only be cultivated by setting up conditions where the freedom of individual scientists to pursue their own hunches is protected.

The "order" we find in a spontaneous order process may be closely akin to that of a story whose plot we can "follow" without claiming to be able to anticipate it from the outset. Here the theory of narrative as it has been developed in the study of history and fiction is relevant to scientific explanation. As the philosopher Paul Ricoeur has shown, the articulation of history has an irreducibly narrative character, and good history shares many of the attributes of good fiction.[5] Essentially to impart the subjective meaning and significance of events in history involves us not in a mechanistic search for determinate laws but in

[4]For a useful summary of the contemporary philosophy of science literature in terms of this contrast between monological and dialogical processes, see Bernstein (1983).
[5]See Ricoeur (1983, 1984).

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the uniquely human act of storytelling. As Ricoeur (1981, p. 277) put it:

> [T]o follow a story is to understand the successive actions, thoughts, and feelings as displaying a particular directedness. By this I mean that we are pushed along by the development and that we respond to this thrust with expectations concerning the outcome and culmination of the process. In this sense, the "conclusion" of the story is the pole of attraction of the whole process. But a narrative conclusion can be neither deduced nor predicted. There is no story unless our attention is held in suspense by a thousand contingencies. Hence we must follow the story to its conclusion. So rather than being predictable, a conclusion must be acceptable. Looking back from the conclusion towards the episodes which led up to it, we must be able to say that this end required those events and that chain of action.

It is this kind of intelligibility of the process that we can aspire to in trying to understand complex orders. If we implicitly identify all scientific explanation with the standards applicable to understanding mechanisms, we will never see anything "out there" in the universe but the relatively timeless and simple mechanisms. For example, we will not see ourselves or our accomplishments. When we can find only cold mechanism in nature, our own creative achievements in science and elsewhere appear to us as inexplicable mysteries.

A machine is understood when it is fully under the control of its user. A philosophy that sees everything as a machine will naturally put the idea of control at the very center of its view of reason and science. By contrast, spontaneous order analysis prefers a notion such as cultivation. A spontaneous order is not designed and never really under our control, since it evolves according to a logic all its own. This does not mean, however, that we are utterly helpless to exert influence over the workings of such ordering processes. Its order may be intelligible in terms of general principles, and these principles may well show us that some environments are more conducive to its self-ordering process than others. Understanding a spontaneous order may enable us to tailor the general conditions for its flourishing. But if we persist in trying to control the detailed working of this kind of process, we are more likely to interfere with its own logic and obstruct its self-ordering, than to intelligently "guide" it in any sense. Attempting to control a spontaneous order is like trying to fix a complex machine, whose detailed workings we do not know, by throwing a monkey wrench at it.

The socio-political consequences of modernism's view of knowledge as control are suggested when we consider that other people are part of what we want to know about. The more the modernist

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view of science advances into the human sciences, the more threatened we find our freedoms. The modernist notion that understanding something means controlling it leads to the attempt to control our own society as we might control a machine we built ourselves. Social engineering in turn has led not only to a loss of freedom for those not in control of the social "steering" mechanism, but, to the surprise of many, it has led to a loss of social order. The great paradox of modernism is that while born in the aspiration of freedom and control over our world, it has brought us now to a position where we seem to have neither. The more bold and ambitious the attempts to control our world, the more irrational "chaos" we seem to generate, and the less freedom we seem to enjoy.

Scientific Socialism: Old and New

> For more than half a century the belief that deliberate regulation of all social affairs must necessarily be more successful than the apparent haphazard interplay of independent individuals has continuously gained ground until today there is hardly a political group anywhere in the world which does not want central direction of most human activities in the service of one aim or another. It seemed so easy to improve upon the institutions of a free society which had come more and more to be considered as the result of mere accident. . . . To bring order to such a chaos, to apply reason to the organization of society, and to shape it deliberately in every detail according to human wishes and the common ideas of justice seemed the only course of action worthy of a rational being.
>
> —F. A. Hayek ([1935b] 1948, p. 119)

In many respects Marx's critique of capitalism already involves an embryonic critique of modernism. It points to a vision of a society where persons are treated as beings in control of their own lives rather than resources to be manipulated by others. Marxism might even lay claim to being the first systematic attempt at a social critique of modernism. Philosophically it contains suggestions of the radical significance of time and genuine novelty in its dialectical approach. Economically it is concerned with disclosing the dynamic and historical forces of social change and not some fixed, eternal structure. It contains a vigorous critique of the attitude of naturalism and insists that there are profound methodological consequences from the fact that in the social sciences man studies himself and not an alien objective world. It condemns bourgeois ideology for its failure to dig beneath the simple and static appearance of social reality and to see the more complex and dynamic processes going on in society. In these and other respects Marxism can be said to be a social theory

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that is in the spirit of the new view of science, indeed amazingly so in light of when it was first developed.

But Marx and his followers in the late 19th and early 20th centuries could not have anticipated the momentous transformation of science that has taken place by now. Orthodox Marxism implicitly retains many elements of unmistakably modernist thinking, and I would like to argue that it is these very elements which have led to the main difficulties in this century's experiments with socialism. I will focus on the central theme by which Marx engages in a radical critique of capitalism: his analysis of its chaotic and undemocratic form of organization. The ultimate emancipatory goal of Marxism, to build a more rational and more democratic society, is inhibited by defects in the critique of capitalism, and the new conceptions of science enable us today to find a way to correct these defects.

The point of correcting what I consider defects in the traditional Marxian critique of capitalism is not to try to rescue historical capitalism from the critique, but to help reconstruct a better alternative to both historical capitalism and socialism. I would not deny the fact that there are serious difficulties in the way state capitalism works, for example, in the recurrent business cycles, stock market crises, unemployment and inflation problems, and so on.[6] Of course historical socialist regimes have their own share of difficulties, but contemporary socialists have good reasons not to want their reforms to aim at nothing better than what historical capitalism has accomplished. My purpose here is not conservative but radical. I want to explore how we might update the critique of capitalism in such a way as to improve our vision of an alternative to both it and the versions of socialism we have seen so far.

It is well known that Marx said little directly about how socialism was supposed to work, and he devoted his attention to a critique of capitalism. This procedure is misunderstood if it is taken as an opportunity to freely invent any model of socialism, however foreign to Marx's own way of thinking, and graft it onto his critique of capitalism. The critique of capitalism is not an alternative to the study of socialism but a means of conducting that study. Implicit in the critique is a vision of a society that transcends the problems the critique identifies with the capitalist system. If Marx's critique of the capitalist

[6]I would argue that attempts to centrally control the money supply are responsible for introducing unnecessary chaos into the market process, and that those relatively rare instances in which money and banking were left decentralized and unregulated are also among the most orderly episodes of modern economic history. See White (1984) for a discussion of the experience with relatively unregulated money and banking in Scotland in the early 19th century.

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system needs revision today in light of our new views of science, so must our vision of the alternative system.

While I consider it a perfectly legitimate analytical procedure to develop a vision of social change indirectly by way of a critique, there are likely to be costs to this approach.[7] It is hard to see how socialist institutions might work when they are not "thematized" specifically. I believe that one result of this lack of attention to the institutional details of socialism is a serious tension in Marx's implicit vision of the socialist society, a tension that suggests there is room for some *re-vision*.

Marx was on the one hand asking us to conceive a form of democracy more extreme than advocates of capitalist democracy can usually imagine, a democracy in which the basic direction of social change is a topic for all members of society to have their say about, and thus the form has a radically decentralized character. This aspect of Marx's work is most vivid in his earlier and more philosophical writings. On the other hand he was suggesting that this democratic process should culminate in society settling on a common plan by which the entire economy is to be ordered, and thus the vision has a radically centralized character. The centralized aspect is suggested more strongly in Marx's later and more political-economic writings, and especially in his critique of market institutions as "anarchic."

In his economic critique of capitalism Marx charged that this form of social organization was an "anarchy of production," a system of organization that was "out of control." He was not denying that this system exhibits some degree of orderliness, indeed his whole analysis of the theory of value is an attempt to describe the order that does emerge in this system. But he stressed that the order that arises is brought to the system only haphazardly in the form of periodic crises, which forcefully correct for the disorder that continuously accumulates throughout the system.

The orthodox interpretation of Marxism seeks to correct the undoubtedly chaotic difficulties of historical capitalism by means of a wholesale rejection of market institutions, prices, money, and the profit and loss system. If the whole productive system is to be taken

[7]I have used this procedure myself in my critique of national economic planning (1985b), which was really aimed at a reconceptualization of the nature of a free-market society. I am convinced that it is often necessary to approach one's ideal society indirectly by developing a critique of the features of modern society that one would like to overcome. One should still try to get around eventually to a more constructive institutional analysis, however. Advocates of free-market institutions, like advocates of socialism, might do well to spend more of their time directly on how their proposed ideal institutions might work, and less on deconstructing the ideals of one another.

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over and rationally controlled, then it will not do to permit isolated agents in the economy to act on their own initiative and spend their cash balances wherever they please. It will not do for investments to flow haphazardly in whatever direction profits attract them, regardless of the (democratically decided) plan. It will not do for competitors to struggle against one another for these profits under risk of losses, to bid prices up against one another on the demand side, or to bid them under one another on the supply side. The price system does work as an ordered anarchy, and it seems reasonable—at least for a modernist—to visualize its radical alternative as a system that dispenses with all this chaotic competitiveness and brings the diverse projects of separated decisionmakers into a unity under a common plan.

Marx did occasionally suggest that the way to overcome this chaotic system was to bring the socio-economic system as a whole under the deliberate control of "the associated producers." He used the phrase "dictatorship of the proletariate" (which includes, at the moment of revolution, not just one social class, but virtually the whole of humanity) in an ironic way, which certainly hints at centralized control, but also suggests that somehow everyone would participate democratically in this plan. This approach, like most of Marx's allusions to how socialism might work, is tantalizingly ambiguous. The idea of bringing the whole economy under the control of somebody sounds like extreme centralization, yet the phrase "associated producers" suggests a radically decentralized and democratic form of organization.

Unfortunately, Marx's ambiguous vision of socialism has historically been elaborated in a one-sided way that makes it nothing more than a system of hierarchical central planning. In Lenin's words socialism is organized as a "democratic centralism." That is, a democratic process would first take place by which the goals of society would be determined, and then these goals would be translated into a general plan that would design economic production as if it were a single, gigantic engineering problem. Once the plan was settled, there would be no room for democratic differences. If the society was to be organized "rationally," the plan must be obeyed diligently.

This centralized interpretation has the advantage that it fits well with some of Marx's economic writings, especially his wholesale condemnation of market institutions, but it has the disadvantage that it fails altogether to fit Marx's political vision of human beings in control of their own lives. Centralized economic planning on the orthodox socialist model has been a complete failure in the democratic dimension, and this failure has spawned a renewed focus within the Marxist tradition on the decentralized aspects of Marx's vision.

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Within the Marxian tradition there are powerful intellectual currents that constitute a critique of the social-engineering view of politics that comes from the orthodox Marxists.[8]

Spontaneous Order and the Critique of Orthodox Socialism

> That we have been able to achieve a reasonably high degree of order in our economic lives despite modern complexities is only because our affairs have been guided, not by central direction, but by the operations of the market and competition in securing the mutual adjustment of separate efforts. The market system functions because it is able to take account of millions of separate facts and desires, because it reaches with thousands of sensitive feelers into every nook and cranny of the economic world and feeds back the information acquired in coded form to a "public information board." What the marketplace and its prices give most particularly is a continuing updating of the ever changing relative scarcities of different commodities and services. In other words, the complexity of the structure required to produce the real income we are now able to provide for the masses of the Western World—which exceeds anything we can survey or picture in detail—could develop only because we did not attempt to plan it or subject it to any central direction, but left it to be guided by a spontaneous ordering mechanism, or a self-generating order, as modern cybernetics calls it.
>
> F. A. Hayek (1976, p. 237)

The most important critique that has been raised by economists against the traditional, centralized view of socialism is the challenge

[8]I am thinking of the Frankfurt School of Marxism, and particularly its contemporary leader Jürgen Habermas, whose work on the idea of a communicative ethic involves a radical critique of the modernist view of rationality, and of its corollary, the social-engineering view of politics. See, for example, Habermas's essay "Dogmatism, Reason, and Decision: On Theory and Praxis in Our Scientific Civilization" (1973, pp. 254–55) where he writes:

> The social potential of science is reduced to the powers of technical control—its potential for enlightened action is no longer considered. . . . Emancipation by means of enlightenment is replaced by instruction in control over objective or objectified processes. Socially effective theory is no longer directed toward the consciousness of human beings who live together and discuss matters with each other, but to the behavior of human beings who manipulate. . . .
>
> Yet even a civilization that has been rendered scientific is not granted dispensation from practical questions; therefore a peculiar danger arises when the process of scientification transgresses the limit of technical questions, without, however, departing from the level of reflection of a rationality confined to the technical horizon. For then no attempt at all is made to attain a rational consensus on the part of citizens concerning the practical control of their destiny. Its place is taken by the attempt to attain technical control over history by perfecting the administration of society, an attempt that is just as impractical as it is unhistorical.

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that was first issued in the 1920s by the Austrian school economist, Ludwig Mises, and substantially elaborated by his leading student, F. A. Hayek.[9] This critique concerns the difficulty, perhaps the utter impossibility, of rationally organizing an economy according to a central plan. The "calculation argument" is essentially an application of spontaneous order analysis to economics. The process by which order emerges in the economy is one that can be cultivated but not controlled.

The Mises/Hayek critique of socialism is well known to this day in the field of comparative economic systems and is often credited with having refuted the orthodox Marxian central planning position. I do not think it is generally understood, however, exactly *why* this centralized model fails, and as a result the alternative direction the critique suggests is also misunderstood. All too often economic reformers reject orthodox socialism only to endorse a form of orthodox capitalism that is subject to virtually the same criticism. One form of modernist thinking, one kind of social engineering, is simply replaced by another.

Properly understood, the critique of orthodox socialism is not a conservative defense of the state-capitalist systems prevalent in the West, but a basis for criticizing both traditional capitalism and socialism. The Austrians' challenge is widely thought to have been circumvented by one or both of two standard neoclassical approaches, each of which fundamentally misunderstands the critique it is supposed to answer. The microeconomic answer reduces the problem to a matter of pure, abstract equilibrium theory and thus fails altogether to meet the practical challenge.[10] The macroeconomic answer pro-

[9]The "calculation argument" was formulated, and so named, by Mises in his 1920 essay "Die Wirtschaftsrechnung im sozialistischen Gemeinwesen" and his 1922 book *Die Gemeinwirtschaft* (1936). Mises's original essay, along with similar formulations of this argument by Halm, Hayek, and Pierson, are included in English in Hayek's *Collectivist Economic Planning* (1935a). Hayek's rejoinder to Lange and other relevant essays on the role of knowledge in the economy are included in Hayek's *Individualism and Economic Order* (1948). Summaries of the debate include Armentano (1969), Hoff (1949), Lavoie (1981, 1985a, 1987b), Murrell (1983), and Vaughn (1980). For interpretations of Soviet economic experience in light of this theoretical critique, see Brutzkus (1935), Lavoie (1987a), Polanyi (1951), and Roberts (1971).

[10]The micro answer to the critique of orthodox socialism embodies a new model of socialism, devised by the well-known Polish economist Oskar Lange ([1936] 1964), which is supposed to consist of an ingenious combination of centralized planning with a decentralized price system. Although Lange's answer to this argument is right insofar as it insists that socialism needs to accommodate itself to the price system, it fails to realize the implications of this important change in the vision of a socialist society. Lange thinks socialism can still be centrally planned in some meaningful sense, and he is still ready to condemn the anarchy of capitalist production for being unguided.

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poses a kind of partial planning that has led to serious difficulties of inflation and unemployment throughout the Western world, for reasons the Austrians had warned about long ago.[11] The upshot of both of these interpretations is a simple endorsement of the idea of the "mixed economy," that is, a defense of the status quo economic systems of the West, systems that involve a substantial mixture of markets and state intervention.

I would like to suggest that this complacent defense of interventionism is due to a confusion that is rooted in the very philosophical prejudices I have been calling modernism. Interventionism does not represent either an advancement over traditional Marxism or an effective answer to the Mises/Hayek critique of centralized planning. Thus I would like to offer my own interpretation of this classic critique in order to show both how it represents an instance of spontaneous order analysis and how it points not in a conservative but in a radical direction for economic reform.

The problem the calculation argument raises for the economics of socialism can be described as an application of the new view of science to the study of economic institutions. It depicts these institutions as working in a self-organizing way, establishing order by means of apparently disorderly processes. The argument emphasizes that the production process is fundamentally complex and that its adjustments take place through time by way of irreversible, evolutionary processes.[12] And it is central to the argument that what makes the "structure" of production hang together is the *meaning* that gets conveyed through the price system. The goods produced in the economy are not viewed as objective, physical things, but as intimately connected to human subjects and their purposes.[13]

He has essentially reverted to a conservative defense of interventionism, to a policy of state interference into a market-organized economy. His market-socialist model manages to reconcile planning with markets only by failing to deal with the real problem the critique raised about socialism in the first place. The Langean world is based on the perfect competition equilibrium model from Walrasian economics, and as such fails to grapple with the complexity of the real economy, or with the existence of uncertainty in economic decisionmaking. He depicts the economic problem as if it were a matter of monologically performing an objective calculation, instead of dialogically discovering subjective meaning.

[11]The ideas about "fine-tuning" the economy by management of the money supply and fiscal policy, which have come to be known as Keynesian, were vigorously criticized by the Austrian economists at the same time as they were formulating their critique of orthodox socialism, and for similar reasons. The fine-tuners know as little about what they are doing as do the central planners.

[12]For summaries of the Austrian tradition in economics and the way it grapples with time and complexity, see Rizzo (1979) and O'Driscoll and Rizzo (1985).

[13]For a summary of the Austrian approach to economics that stresses this point about meaning, see Mises (1949).

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The Mises/Hayek critique of socialism contends that any system of common ownership of the means of production is inherently unable to generate and disseminate the scattered and largely tacit knowledge, including knowledge of the relative scarcities of various consumers' and producers' goods, upon which advanced technological production depends. Separate owners actively contending with one another for money profits are able to (undeliberately) impart knowledge to the system of relative prices, and in turn to orient their own actions by reference to their "economic calculations" in terms of these prices, in such a way as to enable the millions of independent decisionmakers to coordinate their actions with one another. Without these prices to serve as "aids to the mind," as Mises called them, the planner would not know how to organize his or her commonly owned means of production with anything close to the degree of efficiency attained spontaneously by the rivalrous workings of the market process. Thus the argument is that there is a practical problem involving the use of knowledge facing any society that attempts to deliberately (and thus non-rivalrously) plan its economic order.

Hayek's later restatements of this argument (1935b, 1935c, 1940, 1976) make increasingly clear the importance of the nature and uses of knowledge to the whole critique of socialism. The problem with centralized planning is a problem in the social use of knowledge. Participants to the market process contribute to the discovery and conveyance of knowledge by imparting their local information to prices and in turn receiving useful information from others that is digested in prices. The challenge shows why socialism cannot afford to completely abolish the price system, as orthodox Marxism intended. Prices represent vital signals that each market participant needs in order to act intelligently.[14]

Now if proponents of socialism take seriously Hayek's argument that the complexity of the planner's task exceeds the capacity of any single mind or organization, the natural response would seem to be to greatly simplify this complex task. Instead of trying to plan the whole economy down to its every detail, as orthodox Marxians had ambitiously proposed, a more modest planning policy might be to just plan major sectors or aggregate categories or particular aspects of the economy. Many proponents and critics of socialism in the 1920s and 1930s assumed that the Central Planning Board would actually keep track of all the intimate details of the individual organization of each factory. Such a view of comprehensive planning is

[14]See also Hayek's related papers on knowledge and competition: Hayek (1937, 1942, 1945, 1946, and 1978b).

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implicit in the traditional interpretation of Marxian socialism, but today it seems so far from the real experience of Soviet-type economies that it sounds almost like a straw man.

The attempts, however, to withdraw from comprehensive planning to more moderate forms of partial planning, or interventionism are illusory. The appraisal of the efficacy of an economic plan can only be made in the context of a specific choice between real alternatives whose opportunity costs can be ascertained. The choices that together impart rationality to economic processes are only meaningful in certain specific contexts. It is not possible arbitrarily to separate out choices about prices from all the other aspects of choices, allocating decisions about price changes alone to the planning board. Neither is it possible for the central planners to decide on overall macroeconomic aggregates while leaving the microeconomic details to be worked out by decentralized decisionmakers. In both cases an artificial division of decisionmaking is being proposed in which the partial decision that the planners are supposed to make is in fact a meaningless one.

The planning board cannot intelligently decide on the price to charge for, say, a new computer program without detailed knowledge of the qualitative characteristics of this good and the costs of its production. For exactly the same reason, the planning board cannot decide on the total "quantity" of all computer programs needed by society without first having detailed knowledge of all the specific programs that make up this aggregate. To pretend to plan the price alone or the aggregate alone and leave the rest to others is to retreat from rational planning as the society's organizing mechanism to arbitrary intervention in a market-organized system. Thus the whole rationale of planning is undermined unless it can be shown how the planners' task could possibly be parceled out or delegated to subordinates without also relinquishing the meaningfulness of the decisions being made.

How, then, is the "intellectual division of labour," as Mises ([1920] 1935, p. 102) put it, accomplished in the market? Here each rival is able to focus his mental capacity on but a part of a complex network of economic relationships whose overall structure no market participant knows. Yet by allowing its participants to adjust their activities to one another through prices, the overall system exhibits an unintended order that makes advanced technological production possible.

The practice of accounting, that is, of the calculation of profit/loss accounts in terms of money outlays and receipts, both ex ante and ex post, has enabled human beings to orient their productive activities to one another in such a manner as to permit social production as a

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whole to be carried on with a very high degree of complexity. The calculation argument contends that in fact this complexity has, in the case of the advanced economies of the modern world, come to far exceed that which could possibly be consciously planned by any single mind or agency. By taking account of one another's decentralized plans indirectly, as mediated through relative price signals, which are continuously registering the competitive tugs and pulls of market participants, we are able to attain a complexity that is unattainable in any noncompetitive and centralized way. Thus the traditional socialist ideal of abolishing the "anarchy" of capitalist production to be replaced by central planning is impossible.

The crucial issue for Mises and Hayek was not primarily how the relative demands for consumers' goods were to be registered without competition, but rather how these consumers' goods evaluations, however determined, could be imputed through the complex network of relationships known as the capital structure. The defining characteristic of socialism throughout the period of the calculation debate was its ambition of abolishing separate ownership of the means of production. Whether we assume the state arbitrarily decides what everyone needs for consumer goods, as Maurice Dobb was to suggest during the debate, or a free market in consumers' goods was to prevail, as advocated by the market socialists, the real problem lies in translating these consumer evaluations into evaluations of producers' goods. Producers' goods prices are not "derived" logically from consumers' goods prices; they are "imputed" through a historical process of competition.

If the means of production are commonly owned, then plant managers cannot openly bid against one another for factors in the kind of competitive discovery process that imparts information to producers' goods prices in a capitalistic market economy. They cannot "play at competition" without putting their own wealth commitments at stake. It is precisely through rivalrous contention by separate and independent owners that market participants are able to impart information to the prices of factors of production, prices that in turn allow them to intelligently appraise alternative avenues of production. Thus the critique of socialism leads directly to the case for shifting the attention of economic policy from the attempt to control specific outcomes to the attempt to cultivate a system of rules in the form of "property rights."

Now there are many conservative economists who will think this critique of orthodox socialism constitutes a case for the status quo of Western economies. These economies, however, have been subjected to ambitious attempts to control them, attempts that are no

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more justified than are orthodox central planning policies. Among the tools of control, for example, is the effort to control money, the very life-blood of market institutions, by means of central banking and monetary policy. Yet the very same reasons why an economy cannot be intelligently planned suggest that its supply of money and credit cannot be either. The severe problems with inflation and unemployment that plague most Western capitalist economies are not due to the fact that they have relied too much on spontaneous market forces, but rather to the fact that they too have tried to control rather than cultivate the economic order.[15]

Conclusion

> We stand at the beginning of a great new synthesis. The correspondence of static structures is not its subject, but the connectedness of self-organization dynamics—of mind—at many levels. It becomes possible to view evolution as a complex, but holistic dynamic phenomenon of an universal unfolding of order which becomes manifest in many ways, as matter and energy, information and complexity, consciousness and self-reflection. It is no longer necessary to assume a special life force (such as Bergson's *elan vital* or the *prana* of Hinduism) separate from the physical forces. Natural history, including the history of man, may now be understood as the history of the organization of matter and energy. But it may also be viewed as the organization of information into complexity or knowledge. Above all, however, it may be understood as the evolution of consciousness, or in other words, of autonomy and emancipation.
>
> Erich Jantsch (1980, p. 307)

Critics of the current reformers in the Peoples' Republic of China have charged that the attempt to borrow from the new view of science is merely another form of "scientism," or "science worship," which fails to leave room for the human element. They also warn that market reformers in Yugoslavia and Hungary have brought those countries a new set of difficulties, including inflation and unemployment, and that freeing up the price system necessarily implies condemning socialism to all the vices familiar to Western state-capitalist econo-

[15]The Austrian economists Mises and Hayek have pointed to the problems with efforts to control an economy by manipulating the supply of money and credit, and they have argued that not only inflation but also much unemployment is traceable to this policy. See Mises (1981) and Hayek (1931). For a useful overview of Hayek's work on economics that shows the common basis of both his critiques of orthodox socialism and of orthodox capitalism in his theory of spontaneous order, see O'Driscoll (1977). The contemporary work on free banking by White (1984) and Selgin (1988) is particularly important in this regard in that it shows specifically how a decentralized monetary system can be more orderly than one that is controlled by central banking policy.

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mies. Both of these criticisms fail to appreciate the new synthesis that is emerging in science in general and within political economy in particular. The choice between being pro-science and pro-human is a false one, a legacy of modernist thinking that is being overcome in the new view of science. There is a third alternative that is at once humanistic and scientific. Similarly the choice between socialism and conservatism is a false one. There is no necessity that when prices are freed up problems of inflation and unemployment will result. There is a third alternative, namely, a truly free society that minimizes the overall role of government and allows the spontaneous forces of the competitive market process to produce social and economic order.

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The Impact and Influence of the New View of Science on China's Reform

He Weiling

Great changes have taken place since the economic system reform was introduced in China in 1978. The reform covers a wide field with different outcomes and significances, predominated by a change in the ways of viewing and ways of thinking. Professor Don Lavoie points out that today in China the economic reformers are taking "the new view of science" as their starting point.

For the last 10 years, the so-called new scientific methodology—such as control theory, catastrophy theory, and dissipative structure theory—was introduced progressively and extensively to the study of social science and greatly enlightened people's outlook and thinking. This change is the result of China's reform on the one hand and the driving force for the reform on the other hand.

The significance of the new view of science, or rather the new way of thinking, is profound. It is a powerful tool that helps us in analyzing the issues concerning social-economic development and reform, and it makes people's way of thinking more identical and practical—especially as it creates a condition for the dialogue between policy-makers and young researchers. On the other hand, the new scientific methodology is also an appropriate way to deal with, to combat, to eliminate, and to renovate the traditional and classical dogmatism.

The new view of science—the new way of thinking—has been applied throughout all the processes of the reform, during which the reform has been penetrating into every corner of the society for the last 10 years.

In consideration of the nature of Lavoie's paper, I will focus my comment on two subjects: (1) the implications of the new view of

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science for China's reform, especially the new view of order and chaos, and (2) a review of China's reform over the last 10 years in light of the new view of science.

A New View of Order and Chaos

The new view of science, as Lavoie points out, adopts a new category of order and chaos. In turn, this change gives rise to a very important perspective in exploring and analyzing social-economic development and social-economic laws in terms of order and chaos. The new view explains especially how the social and economic order develops.

The old way of thinking exaggerated and overemphasized Marxist criticism of the capitalist market economy, overlooking the decisive role the market mechanism plays in economic development. As such, the old view led to state-monopolized planning. When Newton's way of viewing the world was universally acknowledged, all laws (both natural and social) were regarded as absolute, and no one could change them. Adversely, the old view overlooked the importance of human knowledge and reflection; it did not recognize that the participation of human beings in the social-economic process will influence their perceptions as they learn and acquire new information.

The old way of thinking has served as the philosophical basis for the theory of comprehensive planning. As a result, like all socialist countries, China made a detour on its way to economic development, during the founding of the new China, because of the theory of comprehensive planning.

Two Kinds of Order

According to the new scientific view of Prigogine's theory (dissipative structure theory), there are two kinds of order: ossified and alive order. The planning order actually belongs to the ossified order that cannot meet the need of rapid development, which depends on an efficient division of labor and intelligence and on the incessant emergence of new technology and new productivity. Therefore, the planning order is only a primitive order in accordance with a simple economic system.

The centrally planned order will totally collapse in the progress of new technological development and new social subdivision of labor and intelligence. The chaos arising from excessive central planning is self-evident, and has been especially visible during the progress of China's economic reform. And to make matters worse, the planning system could do nothing for resolving the chaos problem by eco-

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nomic means because it could not regulate automatically; that is, under central planning there is no spontaneous self-organizing process. So every time chaos arose, only political movements followed. (In this sense, the question addressed in Lavoie's recent book *National Economic Planning: What Is Left?* is clearly relevant.)

The Problems of Knowledge and Democracy

According to Lavoie, there are two problems that the planning system cannot solve: the knowledge problem and the democracy problem.

As to the first problem, it is not the lack of information, per se, that leads to the ill-practice of planning. It is because the planning system does not align itself with the drive for modernization. Under the planning system, the plan is made by a small number of people or organs. It therefore cannot perform in the same manner as a highly integrated mechanism. Under the planned economy, it is difficult to make any new adjustment and allow for new economic activity. The adjustment problem can be solved only by introducing a market mechanism that can automatically and spontaneously adjust itself by using all kinds of economic measures, including competitive prices, a stock market, and a bond market, as well as by introducing sound monetary and fiscal measures. By doing so, a type of collective social intelligence can replace individual intelligence and the social-economic structure could be transformed into a new order, a higher-level order that can stand the test of time.

One point needs to be emphasized: The market mechanism is not only a key measure for maintaining the balance of demand and supply, but also an important measure for promoting the transformation of the economic system from a lower level of integration to a higher level.

The second problem, the problem of democratic rule, is very clear. Under the old planning system only a small group of people, operating in a hierarchical way, administer and manage the system. Such an arrangement will undoubtedly brew and produce a cumbersome and ossified bureaucratic system.

Theoretically and practically, the establishment of a market-oriented economic system is the prerequisite for modern economic development. This conclusion is quite obvious from the process of the reform as well as from the new view of science, including the concept that the formation of a highly self-adaptive and self-regulating social structure stems from the opening of the system.

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China's Reform Process

The second subject I would like to touch on is a review of the history of the last 10 years of reform.

For the last 10 years, newly born ideas were often subject to much criticism. New ideas always take shape along with any reform drive. New ideas also serve as a pathbreaker for changing and developing an economic system.

During China's reform process over the last decade, there were three stages in the development of the new way of thinking about and viewing economic organization. First, those who accepted the new view of science would not question classical dogmatism directly. They avoided any confrontation with orthodox views, and only advocated a new scientific method, applied new concepts, new technology, and new ways of expression. In the second stage, advocates of the new view reassessed and challenged the analysis of the classical theory of Marxism. Finally, in the third stage, which is now just beginning, there is an open discussion of the market order, ownership, and the role of a stock market in China's socialist system.

Cultivating a Spontaneous Order

Another important concept offered by Professor Lavoie is "cultivation." When we regulate the economic system, cultivation is better than control. In the process of undertaking reform, policymakers should keep two concepts in mind: graduation and cultivation. In that process, the most important thing is not control but cultivation.

We have to liberalize and cultivate but not control the social economic realities in light of the application of laws and principles of economic development by means of the new view of science—using the new concept of spontaneous order, the new methodology, and the new terminology. Only by openly acknowledging the spontaneous and self-organizing process can we fully understand and accept the basic laws in our way toward a higher social-economic order. Otherwise we will be thrown back into chaos and suffer another big setback.

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A Free-Market Constitution for Hong Kong: A Blueprint for China

Alvin Rabushka

China's leaders understand the basis for Hong Kong's stability and prosperity. In particular, they recognize that the adoption of Hong Kong's institutional and policy mix would go a long way toward promoting growth on the mainland. The central message of this paper is that the provisions of Hong Kong's draft Basic Law, which may be regarded as a free-market constitution, can serve as a blueprint for economic reform in China. Likewise, the market-oriented economies of the other Pacific Rim "dragons"—Singapore, Taiwan, and Korea—also provide valuable lessons for China, some of which will be examined along with the Hong Kong model.

Hallmarks of Hong Kong's Economic Success

In contrast with the vacillating economic strategies and policies that prevailed in mainland China between 1952 and 1978, which often reflected ideological struggles over the proper objectives and means to implement socialism, Hong Kong maintained an extraordinary degree of stability in its political and economic institutions. Founded as a free port in 1841, Hong Kong has an economy today that depends on export-oriented light manufacturing industries along with a myriad of servicing industries within a free-port, free-enterprise environment. Highly developed banking, insurance, and shipping systems complement its industrial sector.

A rundown of Hong Kong's fiscal and economic policies reveals a portrait of life that encompasses balanced budgets (almost always in surplus), avoidance of public debt, an economy ethic in government that strives to avoid wasteful spending, an aversion to central planning, minimum intervention in or regulation of the private sector,

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commercial provision of public economic services, a constitutional and legal framework that protects private property and a whole range of personal freedoms, free trade, free movement of capital, avoidance of subsidies to industry, minimally intrusive general business requirements (it takes little time or money to open a business), a free market in labor, and a system of low rates and low overall taxation. In short, free trade, free markets, low taxes, nonintervention, and personal liberty are the hallmarks of Hong Kong's economic success.

The Future of Hong Kong

Hong Kong has experienced several noticeable episodes of political and economic instability since 1949. The two most dramatic occurred in 1966–67 as a spillover of the Cultural Revolution on the mainland and in 1982–84 during the Sino-British negotiations over the future of Hong Kong. As political confidence in the future waned during the talks, the colony experienced a run on the Hong Kong dollar and a sharp decline in stock and property values. The signing of the Joint Declaration in 1984 restored a measure of stability to Hong Kong and the economy quickly resumed its upward economic path. Apart from external political shocks, Hong Kong's resilient capitalistic economy has successfully weathered international recessions, trade quarrels, oil shocks, and internal disputes. Its free-market economy has enabled Hong Kong businessmen to adjust quickly to changing external circumstances.

China's political leaders and economic analysts are well aware of Hong Kong's achievements. They are also aware of the institutions and policies in Hong Kong that have made the territory's remarkable prosperity possible. Over 700 Chinese firms, encompassing banking and finance, travel, shipping, city, provincial and national organizations, insurance and oil companies, and special economic zone organizations, among others, have steadily expanded their direct investments and business activities in the colony, now running into the billions of dollars.[1] In addition, tens of thousands of mainland personnel have been dispatched to Hong Kong to learn how to do business in a market-based economy. The Bank of China group is believed to be the second largest holder of deposits in Hong Kong after the Hongkong and Shanghai Banking Corporation.

[1]These estimates, obtained from the *Far Eastern Economic Review* (23 June 1988, pp. 64–66), reflect a variety of sources including Beijing's own calculations, local Hong Kong university professors, and the U.S. State Department's Foreign Commercial Service. The total capital investment of Chinese-funded enterprises in Hong Kong is estimated to range between U.S. $7–12 billion.

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Chinese political leaders have also learned, especially from the crisis of confidence that erupted in 1983 when the Sino-British talks appeared to be going poorly, that political confidence in the future of Hong Kong is extremely fragile and, if shattered, threatens to destroy its stability and prosperity. A prosperous Hong Kong is deemed essential in China's developmental plans to provide hard currency earnings, to provide access to trade and technology, and to serve as a proxy for the absence of a major Southern port city.

Since 1982, when China publicly announced plans to resume sovereignty and administrative authority over Hong Kong on July 1, 1997, when Britain's 99-year lease on the New Territories is scheduled to expire, Chinese authorities have repeatedly stated their primary objective of preserving stability and prosperity in Hong Kong. To maintain stability and prosperity, Deng Xiaoping advanced the novel doctrine of "one country, two systems," in which socialism on the mainland and capitalism in Hong Kong would peacefully coexist within one sovereign China.[2] In particular, China guaranteed that Hong Kong would be allowed to retain its capitalist way of life for 50 years after 1997 until 2047.

The Draft Basic Law: Lessons for China

Under the provisions of the Sino-British Joint Declaration, Hong Kong is to receive its own mini-constitution. Upon the resumption of the exercise of sovereignty over Hong Kong, China agreed to establish a Hong Kong Special Administrative Region (HKSAR), which would retain a high degree of autonomy in all matters except defense and foreign affairs. The National People's Congress (NPC) of the People's Republic of China will enact and promulgate a Basic Law by 1990.

In April 1985, the NPC established a drafting committee for the Basic Law of the HKSAR, which comprised 59 members, among whom 23 were from various sectors in Hong Kong. To ensure that the drafting committee received a wide range of public opinion within Hong Kong, it set up a consultative committee of 180 persons reflecting the various sectors and strata in Hong Kong. In April 1988 the drafting committee issued a draft Basic Law, on which it solicited

[2]Chinese officials hope that the successful application of the "one country, two systems" doctrine in Hong Kong would provide a mechanism for the gradual unification of Taiwan with the mainland on a similar basis. That is, socialism in China and capitalism in Taiwan could peacefully coexist within one sovereign political system. Failure of the "one country, two systems" experiment in Hong Kong would make it virtually impossible to extend the same doctrine to Taiwan, thereby thwarting reunification.

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opinions from the general public during May-September 1988. Following amendments and revisions, a second draft Basic Law was issued in February 1989, on which consultation was scheduled through July 1989. Following another bout of further possible amendments and revisions reflecting the second round of consultation, the final version is scheduled to be promulgated by the NPC sometime in 1990.[3]

The draft Basic Law contains a statement of general principles, along with chapters that enumerate the relationship between the HKSAR and Chinese central authorities, the fundamental rights and duties of Hong Kong residents, political structure, the economy, social services, external affairs, interpretation and amendment of the Basic Law, and a variety of supplementary provisions. The draft also contains a preamble that states that the mainland's socialist system and policies will not be practiced in Hong Kong.

To the best of my knowledge, the proposed Basic Law for the HKSAR is unique among contemporary national constitutions in one respect: It enshrines general principles and concrete policies to preserve individual economic freedom. It does so because Chinese authorities recognize that the preservation of economic freedom in Hong Kong is critical to its continued stability and prosperity. The list of economic liberties is in addition to a standard list of civil rights that normally appears in a constitutional document. A review of the economic provisions in the draft Basic Law for the HKSAR provides lessons that China can bring to bear upon its own development.

Importance of Private Property Rights

Perhaps the most fundamental individual economic right of all is itemized in Chapter I in the draft Basic Law, which sets forth general principles. Article 6 (of Chapter I), in particular, protects rights of private property relating to acquisition, use, disposal, inheritance,

[3]This process has been politically charged. Some advocates of direct democracy in Hong Kong assert that a coalition encompassing local big business, the colonial government, and Chinese authorities has conspired to minimize the extent of political reform in Hong Kong to ensure that when China takes over in 1997 it will retain an iron grip over the HKSAR's new political structure. Opponents of rapid democratic reform argue that direct democracy imperils Hong Kong's stability and democracy and that democratic reforms need to be introduced gradually. This paper, however, focuses almost exclusively on questions of economic policy, not political structure, and therefore the political structure of Hong Kong is not discussed.

Throughout this paper, citation of specific articles in the draft Basic Law refers to the April 1988 version. Some renumbering and rewording of articles transpired in the second draft, but the main provisions in the first draft largely remained in force. It is presumed that all of these provisions will be preserved in the final version.

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and compensation for lawful takeover at market prices in convertible forms of payment. Private property rights are the keystone of Hong Kong's market economy and their preservation is essential in maintaining Hong Kong's capitalistic system. By way of contrast, China is in the very preliminary stages of injecting property rights into its socialist economic system. Prior to 1982, individuals could not own land, which belonged to the state. Revisions to the constitution in 1982 allowed for the development of "individual" economy and gave citizens the right to own houses and inherit private property. Rural economic policies, begun in 1978, have created a de facto system of property rights in agriculture, in which peasants can inherit or trade 15-year leaseholds to specific plots of land, and agricultural output has sharply increased in response to these new individual incentives made possible by a system of property rights in agriculture. State or collective ownership remains the primary form of urban and industrial ownership. To improve industrial efficiency, China will have to make major strides in creating and enforcing a system of private property rights in urban land, business ownership (other than very small enterprises that are currently private), and a variety of financial assets.[4] China's attempts to reduce and phase out urban food subsidies will have to encompass the government's control over housing, jobs, and other amenities. Since Chinese urban residents have enjoyed housing and food subsidies for decades, phasing out subsidies and moving to a system of private ownership will be extremely difficult.

Maintaining a Rule of Law

Private property flourishes only within a framework of the rule of law. Article 8 stipulates that the laws in force in Hong Kong, including common law, customary law, and legislation, shall be maintained. Retention of the existing legal system serves to protect private property rights. In particular, the British legal system, arising from the common law, is especially concerned with protection of private property. Confidence in the legal system requires an independent judiciary, which is provided in the draft Basic Law; it shall have jurisdiction on all affairs arising within Hong Kong, except cases relating

[4]Several delegations of Chinese economists from academic institutions, the State Council, the Chinese Academy of Social Sciences, and the Economic Structure Reform Commission have visited Stanford University. They have indicated that the topic of reforming ownership rights of property is an issue in internal debate along with the important task of price reform. The debate centers around the speed with which some measure of private property rights can be injected into the industrial urban economy. There is growing recognition that price reform without property reform will not yield the maximum gains in economic performance.

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to defense and foreign affairs. China, in contrast, lacks a fully articulated legal system that would permit contract disputes to be resolved with some measure of certainty. As well, the judiciary is more an arm of the government that seeks to implement state policy rather than settle disputes among individuals on a totally impartial basis. China will need to forge ahead with the development of a national commercial legal system that serves both the Chinese and international business communities and with the development of a court system that applies the law impartially.

Fundamental Rights and Duties

Chapter III of the draft Basic Law enumerates fundamental rights and duties of the residents: equality before the law; the right to vote; freedom of speech, association, assembly, and trade unions; the prohibition of unlawful search and seizure; freedom and privacy of communications; freedom of movement; freedom of occupation; freedom of academic research; the right to legal counsel; and so forth. These rights are virtually identical with those enumerated in Chapter Two of China's own national constitution and thus offer nothing new in terms of economic principles. In reality, most Hong Kong residents have enjoyed these rights relatively free from government interference. In China, these rights have often been suppressed. Few Chinese subjects have enjoyed freedom of occupation, movement, and academic research on sensitive topics, though the situation has improved in recent years. Freedom of occupation and movement, in particular, are important to moving labor to where that economic resource can be used more efficiently.[5]

Economic Policies for Stable Growth and Prosperity

To preserve prosperity in Hong Kong and to maintain the region's capitalist economy, the Basic Law Drafting Committee members, of whom the majority are mainland Chinese schooled in the socialist system, have enunciated a set of economic policies that govern the conduct of public finance and taxation, money and finance, external trade and economic relations, industry and commerce, land leases, shipping, and aviation. These policies are regarded as the keystone of Hong Kong's prosperity. Indeed, knowledgeable Chinese recognize that these policies are generally conducive to fostering a climate

[5]Since 1949, the government in China has generally assigned most jobs. Chinese are attached to work units, which carry housing, ration coupons, and other benefits. Few Chinese are free to leave their jobs and take up others without official permission, nor can employers summarily dismiss employees. China will need to develop free labor markets, as exist in Hong Kong, to gain maximum benefit from its large labor force.

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for economic growth. The issue in China is how to overcome the political obstacles and historical conditions that prevent rapid implementation. These economic policies are set forth with remarkable clarity in Chapter V of the draft Basic Law.[6]

Public Finance and Taxation. Two themes have historically governed the conduct of Hong Kong's public finances. First, low rates of direct taxation stimulate work, saving, and investment, thereby fostering high rates of economic growth. Moreover, in Hong Kong's open economy, deficit financing is inappropriate since any increase in public spending can leak overseas. Balanced (surplus) budgets are considered the norm of sound fiscal policy. Second, the size of the public sector must be kept small to prevent it from crowding out the private sector.

Article 107 stipulates that the HKSAR shall continue to practice a low tax policy, which means that any expansion in public sector spending must come either from the fruits of economic growth or by substituting spending in one program for another. Article 105 links Hong Kong's low tax system into a budgetary policy which requires that, taking one year with another, revenues and expenditures remain in balance. To ensure that the public sector does not grow in relative terms, the policy also stipulates that the rate of increase of taxes or spending shall not exceed that of the gross domestic product. These provisions ensure that the government will remain limited in its scope and size, which means that the creation and distribution of income is left in private hands.

In general, China has pursued a conservative fiscal policy, mindful of the fact that inflation destroyed the political basis of support of the Nationalist Party. Until recent years, China's command and control economy had little need for a formal system of taxation, since nearly the entire economy was under public ownership in which the government supplied all inputs and collected all receipts of industry. As China moves in the direction of injecting market forces into its economy, it will replace its system of allocating and collecting funds by a system of taxation based on salaries and profits.[7] It must gradually

[6]It is somewhat ironic that a socialist system is setting forth specific economic rights in a constitution that will apply to a portion of its own territory considering that no Western industrial capitalist democracy contains similar measures in its own constitution.

[7]Chinese venture capitalists have complained that rates of taxation on business profits have risen from 55 percent to nearly 80 percent in the past few years, thus adversely affecting incentives. As well, a steeply graduated personal income tax with a top marginal rate of 60 percent was enacted in 1987, ostensibly to capture a share of the windfall benefits that accrued as prices were deregulated. Nonetheless, it seems counterproductive to tax heavily the class of investors, self-made entrepreneurs, and skilled

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reduce the scope and size of the public sector to insure that resources are used efficiently either in private hands or under autonomous management. The lesson that Hong Kong provides is that low rates of taxation and limited government supply strong incentives to individuals.

Money and Finance. Hong Kong is an international financial and banking center. Indeed, the financial services sector is the most rapidly growing part of its economy, now contributing nearly one-quarter of gross domestic product. The draft Basic Law addresses the features of money and finance that foster a prosperous financial sector in Hong Kong.

To begin with, the draft Basic Law requires that the HKSAR shall continue to practice free and open monetary and financial policies. In particular, this calls for the following provisions: No exchange controls shall be imposed in the HKSAR: free flow of capital within, into, and out of the region; free entry into financial business and financial markets; and maintenance of a freely convertible Hong Kong currency (backed up by a reserve fund of no less than 100 percent freely convertible foreign currency). Hong Kong is to retain a free market in money.

The contrast with China could not be more striking. China lacks even rudimentary domestic capital markets. Exchange controls severely limit access to foreign currency. The Renminbi, China's national currency, is not freely convertible into foreign currencies by Chinese or foreigners, nor is it backed by any foreign currency or commodity. The banking and financial services sectors are not open to free internal or external competition. The state exercises disproportionate control over the allocation of credit and investment, though it is moving away from grants and subsidies to the use of interest rates. Before China can deploy its scarce capital efficiently, it will have to create capital markets in which the supply of credit and capital is carefully matched with those individuals and organizations that can use them most efficiently.

Trade and Industry. Sections 3 and 4 (in Chapter V of the draft Basic Law) combine to ensure policies of free external and free internal trade. Specific articles are written to ensure that the HKSAR shall continue to do business on the basis of external free trade, and to that end the free movement of goods, intangible assets, and capital

workers upon whose efforts China's growth depends. Hong Kong's top marginal tax rates, in comparison, range between 15 percent and 16.5 percent for personal income and profits, respectively.

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shall be maintained. Foreign investment shall be protected by law. The region shall remain a free port, true to its historical founding principles dating back to 1841. Finally, the HKSAR shall practice free and open policies regarding industry, commerce, and other trades. This latter provision is designed to ensure free entry and exit into most lines of economic activity (except such regulated monopolies or licensed franchises as power, telephone, and transportation). These provisions require that prices remain unregulated and that the price mechanism adjust supply with demand, both on internal and external markets.

Once again, the contrast with mainland China is marked. Foreign trade has largely been governed by the Ministry of Foreign Economic Relations and Trade. Recent progress has been made in granting various enterprises the right to buy and sell in world markets with fewer restrictions than in the past, but China is a great leap away from any semblance of free external trade. Similarly, the bulk of industrial output is still generated by state-owned enterprises or collectively owned enterprises in accordance with state directives.

The remaining provisions in the draft Basic Law pertaining to economic policy maintain existing land use rights, retain the territory's existing system of private shipping business, and continue the existing system of civil aviation management and Hong Kong-licensed air carriers.

No article in Section V specifically deals with the subject of business regulation, which potentially affects the costs of doing business in Hong Kong in the form of fringe benefits, environmental controls, and so forth. The general principles in Chapter I state that the existing capitalist system and way of life shall not be changed for 50 years, which implies that the general policy of nonintervention in the private sector shall be maintained. The existing system also eschews subsidies to consumers or business firms. There is, curiously, a specific provision to maintain the existing social welfare system, but its chief hallmark is that it consumes a relatively modest share of national income and does not typify the vast schemes of costly welfare programs found in the Western democracies.

A Free-Market Constitution

The Basic Law Drafting Committee was not content to rest with a statement of general economic principles. It believed that confidence in Hong Kong's future required a detailed specification of economic institutions and policies in the form of a free-market constitution. The chief features of this "constitution" include private property, the rule of law, freedom of occupation and movement, low taxes, a

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limit on the scope and size of government, free movement of capital, a convertible (fully backed) currency, free entry into any line of business, unregulated prices, free trade, and the retention of a free port. These provisions were judged to be the *sine qua non* of Hong Kong's stability and prosperity.

One is tempted to suggest that China turn over the management of its economy to the Hong Kong government. But a good substitute for that recommendation is for Chinese economic planners to study the draft Basic Law for the HKSAR, which was written by a China-dominated committee, in which its own members displayed their understanding of Hong Kong's free-market economy. Of course, the drafters were not encumbered with an official ideology of socialism for the HKSAR, which hampers efforts at market-oriented reforms on the mainland. It would be vastly more difficult to copy Section V of the Hong Kong Basic Law into China's own constitution, even though policymakers are grappling with the means of injecting reforms that create equivalent incentives. The critical fact, however, is that Chinese officials clearly recognize the policies that are conducive to prosperity, and in doing so implicitly recognize the need for a free-market constitution.

Lessons from the Other Dragons

Singapore, Taiwan, and Korea differ from Hong Kong in many respects, and numerous books and articles have been written stressing the uniqueness of each country's developmental experience. However, one can discern a common mix of institutions and policies that propelled each into the ranks of industrial modernity within the short span of a generation.

Singapore, Taiwan, and Korea each endured major wartime disruption, each lacked abundant natural and financial resources, and each was a poor country with a low standard of living. All three initially embarked on a program of import-substitution behind a protective wall of tariffs and quotas. All sought foreign aid. Growth under this initial strategy was at best moderate.

External circumstances prompted the leaders of all three countries to switch strategies from an import-substitution policy for a limited domestic market to the development of labor-intensive, manufactured goods for export to world markets. International price competition replaced domestic subsidies and tariffs; private firms decided what to produce and where to sell. Government relaxed its grip on the economy and allowed the marketplace to determine the pattern and scope of economic development.

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What were the major ingredients that went into a successful strategy of growth? To begin with, emphasis was placed on the private sector for the creation of jobs and the distribution of income and wealth. Although the government in each country played a role in allocating credit, building infrastructure, and guiding development, by and large, the private sector was the primary engine driving growth. This strategy required a system of private property rights that would protect both domestic and foreign investors.

Another critical factor was reform of the exchange rate system to ensure that each country's currency was not overvalued. An overvalued currency cheapens imports, makes exports more expensive thus hampering their growth, and invariably leads to a balance-of-payments crisis.

Other important factors included stabilizing the labor market to give foreign and domestic investors confidence that strikes and labor agitation would not distort investors' calculations of profitable investments. All three governments adopted a number of measures to encourage national savings and capital formation, and each country quickly developed extremely high rates of capital formation. In every case, tax incentives were used to encourage foreign and domestic investment, which included such devices as tax holidays, accelerated depreciation, duty-free export processing zones, credits for exports and research and development, special low rates of tax, preferential treatment in the form of low rates imposed on interest and dividends, and exempting capital gains from taxation. A final emphasis was the need to hold down spending on social programs until high rates of economic growth provided sufficient revenues to finance a growing list of government programs out of growth, rather than at the expense of growth. As well, each country tried to run their utilities and government economic enterprises on a commercial basis in which services were priced to reflect full opportunity costs, rather than depend on heavy subsidies.

Conclusion

The standard of living of the four dragons—Hong Kong, Korea, Singapore, and Taiwan—has caught and surpassed a number of European countries. Moreover, the dragons continue to enjoy near double-digit growth rates in the late 1980s. In my view, the single most important factor that accounts for their economic success is that each country affords its residents a considerable measure of economic freedom. This factor translates into a well-defined and enforced system of private property rights, an effective legal system that protects

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the individual's economic and political liberties, reliance on private enterprise for the creation and distribution of income, and the maintenance of economic policies that motivate and reward individual behavior.

China itself would no doubt like to become the fifth dragon and has taken a series of bold measures to that end. Careful study and application of the economic institutions and policies that propelled the four dragons from third-world to first-world status provide a clear set of measures that can assist China in its effort to modernize.

Chief among these measures are the principles and economic policies incorporated into Hong Kong's free-market constitution, as set out in the draft Basic Law. By applying this blueprint to the economic reforms in China, the basis will be established for a new Chinese order characterized by individual freedom and prosperity.

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Freedom and Reform in Asian-Pacific Economies

Richard Y. C. Wong

A commentator is expected to find faults with what the author has to say, but I find myself in substantial agreement with what Alvin Rabushka has written. My comments, therefore, are largely directed at certain omissions in Rabushka's paper, whose inclusion I think would make his case for economic freedom convincing. In particular, I believe Rabushka's argument would be enhanced by taking a more thoroughgoing comparative institutions approach, and that his treatment of the draft Basic Law would benefit from a closer examination of the implementation problem and those provisions that clash with economic freedom.

A Comparative Institutions Approach

The Asian Pacific region provides many useful examples of economies that are great successes or dismal failures. Much can be learned from comparing and contrasting the different institutions and policies adopted by these countries as they developed over time. A comparative analysis of the varying economic growth experiences of these countries would provide useful lessons for China.

The major omission in Rabushka's paper is that he does not make full use of such comparisons, although he does so to some extent elsewhere (see Rabushka 1987). Here, he simply concentrates on some of the success cases. A useful comparative analysis, however, must contrast success with failure and bring out the essential differences between them.

Rabushka does distill from the success stories, based primarily on the experience of Hong Kong, a number of policies that he regards

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as essential for economic success. These policies include the protection of economic and personal liberties through the creation of a sound legal framework, the maintenance of a competitive price system, and a tax system conducive to saving and investment. The problem, however, is that Rabushka does not spell out in sufficient detail which of the various policies are most important for China and how they can be implemented given existing constraints and opportunities.

These are difficult issues, but the experience of the Asian-Pacific countries offers some guidance. The strategy adopted by and the experience of Taiwan—and to some extent South Korea, Singapore, and post-Sukarno's Indonesia—in deregulating the economy, scaling back protectionist policies, raising suppressed interest rates, and letting the exchange rate be set close to market levels are highly relevant. Indeed, the political and economic strategies, which are pursued by these governments—with varying success and in the face of opposition—to achieve a general move toward a more open and competitive system in which prices reflect scarcity values, deserve detailed examination. The adopted strategies provide hints as to what priorities should be set and what steps should be taken in implementing a policy of successful liberalization. One general observation is that few countries began by relaxing all prices at once; instead, most tried to focus on interest rates and exchange rates.

There are also negative experiences. In the 1970s, South Korea backslid into greater protectionism and suffered from it. The manipulative industrial policies in Singapore in the 1970s paved the way for a loss in economic responsiveness during the worldwide recession in the early 1980s, which hit Singapore with unusual severity. In some countries, state monopolies simply became private ones without resulting in much improvement in economic efficiency and often generated significant social unrest because inequities and corrupt practices became more evident.

Another major issue is the extent to which these policies can be carried without the creation of new institutions and a fundamental change in the organization of the economy and even the polity. Within China there is an ongoing debate about the appropriate policy mix on the one hand and fundamental reform on the other. The Chinese authorities seem to have achieved some limited consensus regarding the need for basic reform, but the issue of pace and how far it should go remains highly contentious.

Here again the Asian-Pacific economies provide many important lessons. The case of North and South Korea (or for that matter East and West Germany) is a powerful illustration of Rabushka's claim

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that "economic freedom" in the Asian dragons is "the single most important factor that accounts for their economic success." In particular, the experience of the four dragons strongly suggests that modernization requires not only the adoption of sound economic policies, but also the creation of an institutional framework based on private initiative and competition.

Even within capitalist countries, where private property rights are recognized, economic policy failures are quite common and are primarily associated with the fact that highly interventionist governments often impede the process of price competition and hence the individual's economic freedom to engage in production and exchange. Arbitrary transfers and barriers to entry weaken private property rights. Marco's Philippines, Sukarno's Indonesia, and to a lesser extent Malaysia, South Korea, and Taiwan in the 1950s were not success stories, largely because the wrong policies were pursued. A proper institutional framework is essential and will be strengthened by the consistent application of free-market policies. Interventionist policies can erode even the best-designed institutions.

The Draft Basic Law: Its Implementation and Inconsistency

One of the most interesting experiments in the Asian-Pacific region, of course, is Hong Kong, which will have a fundamental change in its political system after 1997. Whether such a change also would bring with it a gradual change in economic policies that over time would weaken the present institutions, which allow a great measure of individual economic freedom, is a matter of great concern. The draft Basic Law, which would serve as the constitution for Hong Kong after 1997, may provide some limited hints of likely future events.

According to Rabushka, the fact that China is willing to enshrine many of the successful policies adopted by Hong Kong in the draft Basic Law demonstrates China's recognition of the value of these policies in leading to economic success. The only remaining issue for Rabushka appears to be for China to adopt these policies for her own modernization. While I think there is much truth in this, there are two fine distinctions that should be noted.

First, the challenge facing China in overcoming the political and economic obstacles blocking the path toward reform is much more formidable than merely preserving policies that have proven successful in Hong Kong. For this reason, the problem of how to implement "a free-market constitution" in China is at least as important as

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what such a fundamental law should include. Second, the draft Basic Law is itself not an unambiguous document or "blueprint for China." Rabushka has correctly pointed out that the draft Basic Law includes many articles that aim to limit the arbitrary power of the state in economic policymaking and to preserve individual economic freedom. But he fails to emphasize that it also includes articles to the contrary, for example, the provision that the state should actively promote industries. The enforcement of this provision would open the way for the introduction of preferential and interventionist economic policies. In many ways the draft Basic Law is necessarily a contradictory document. It hopes to incorporate the interests of various parties—both within and outside Hong Kong—whose goals are dissimilar and whose time horizons are different.

Finally, in considering freedom and reform in Asian-Pacific economies, the role of the political system in determining economic policies needs further scrutiny. It is not sufficient to enumerate sound policies and institutions. Why do some countries adopt "free-market constitutions" and others do not? In answering this question, it is necessary to go beyond Rabushka's analysis to something more fundamental within the political system. The task is obviously difficult, and I am not sure that the experiences of the Asian-Pacific countries have given us clear lessons on this account—much work remains to be done.

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Economic Deregulation in the United States: Lessons for America, Lessons for China

William A. Niskanen

Over the past decade, the federal government of the United States has eliminated or substantially reduced the regulation of price and entry in domestic aviation, trucking, railroads, interstate buses, ocean shipping, long-distance communications, energy, and financial institutions. In addition, the federal government eliminated the general controls or guidelines on prices and wages throughout the economy.

The focus of this paper is on the lessons that might be learned from the U.S. experience with economic deregulation. For the United States, deregulation has caused certain problems but, in general, the net benefits have been higher than first expected. Although the political and economic system in China is very different from that in the United States, the American experience with economic deregulation may also provide some important general lessons for China.

Political Lessons

For a political economist, the political lessons from the U.S. experience with deregulation are the most intriguing, seeming to defy much of the conventional wisdom. The processes that led to deregulation of most of the above industries shared the following five general characteristics.

First, deregulatory actions were initiated by the regulatory agencies. About the same time that economists concluded that the regulatory commissions were "captive" of the regulated industries, the commissions began to prove them wrong. The Federal Communi-

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cations Commission (FCC) was the first to declare independence, allowing competition in telephone terminal equipment in 1968 and progressively broader competition in long-distance communication beginning in 1969. The Civil Aeronautics Board (CAB), following an internal staff study, began to relax price regulation of domestic airlines in 1976. The Interstate Commerce Commission (ICC) broadened the allowed bands on trucking rates in 1976 and relaxed entry controls in 1978. These and other commission actions provided tests of the effects of partial deregulation before Congress considered changes in the regulatory legislation.

Second, there was very little popular support for deregulation, even though consumers would be the major beneficiaries. Consumer satisfaction with airline and telephone service was especially high, and the general public was only vaguely aware of most forms of economic regulation. The support of general business groups for deregulation was late to develop and was broad but not deep.

Third, opposition to deregulation by the regulated firms was first broad but was not sustained. The prospect that the regulatory commissions, with presidential support, would pursue deregulation under the existing law led to the erosion of opposition to the regulatory reform legislation by the regulated firms. The strongest and most enduring opposition to deregulation was from the labor unions in regulated firms. In retrospect, it appears that both the regulated firms and their unions underestimated the extent to which deregulation would undermine the wage structure in these industries.

Fourth, the substantial reduction in economic regulation began during a period in which there was a sizeable increase in the "social" regulation of health, safety, the environment, and the uses of energy. The reduction of economic regulation, thus, did not reflect a general reaction against regulation but was a response to conditions specific to the deregulated industries.

Fifth, a number of conditions appear to have been associated with the selective success of the deregulation movement: There was a convergence of *elite* opinion on deregulation issues, including a near unanimity of economists; both the support and the opposition to economic deregulation was bipartisan; the deregulation measures were represented as pro-consumer rather than pro-business; a developing concern about increasing general inflation broadened the support for deregulation; some amount of deregulation was possible without new legislation; and the support of three presidents was necessary to sustain the momentum for deregulation by the commissions and to speak for the general interest.

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In their recent book, *The Politics of Deregulation*, Martha Derthick and Paul Quirk (1985) reflect on the political lessons from U.S. deregulation and conclude that the deregulation measures were

> achieved through the politics of ideas—specifically through the fusion of expert analysis with public opinion—and suggest that the political victory of a diffuse interest over particularistic interests, though due in part to special features of these cases, was not an aberration. Rather, it shows that the U.S. political system has a greater capacity for transcending narrow interests than has generally been acknowledged.[1]

My hope is that "the politics of ideas," a concept that the Chinese may have invented, has a similar success in China.

Economic Lessons

For economists, although not for many others, the economic effects of the deregulation of price and entry in the targeted industries were less surprising. A review of these effects, however, is useful in evaluating the prospects for similar measures in other industries and other countries.

Transportation

The general effects of the deregulation of domestic transportation have been expanded service, lower rates, and higher productivity.

Since Congress approved the Airline Deregulation Act of 1978, the number of city-pairs served by more than one airline increased by 55 percent, flights to smaller cities increased by 20–30 percent, and service has been expanded to 140 additional airports. About 90 percent of air travelers now use discount fares, and average real discount fares declined about 10 percent on short flights and 35 percent on long flights. Airline productivity also increased. Since the CAB initiated partial deregulation in 1976, the percentage of passenger seats occupied increased from 55 to 60 percent, and airline productivity increased by over 7 percent. On net, the effects of domestic airline deregulation appears to have increased benefits to travelers by about $11 billion and by about $4 billion to the airlines.[2]

The effects of the substantial deregulation of trucking are similar. Since Congress approved the Motor Carrier Act of 1980, the number of authorized carriers has nearly doubled, and the restrictions on the

[1]Bruce K. Maclaury in his Foreword to Derthick and Quirk (1985, pp. vii–viii). This book is the best summary of the conditions that led to the deregulation of airlines, trucking, and communications.

[2]These figures were compiled from the *Economic Report of the President* (1986, 1988).

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licenses of many existing carriers were removed. A recent survey found that average real rates declined about 25 percent for small shipments, and other surveys indicate a general improvement in service.[3]

The Staggers Rail Act of 1980 authorized a partial deregulation of rail rates. Most bulk commodities are now shipped at private contract rates; average real revenues per ton have declined about 11 percent for coal and 33 percent for farm products, despite a small increase in the average distance shipped. Rail-car utilization increased about 10 percent and ton-miles per employee increased 44 percent in the first four years, substantially increasing the profitability of what had recently been a sick industry.[4]

(Experience under the Bus Regulatory Reform Act of 1982 and the Shipping Act of 1984 has been too brief to provide comparable summaries.)

Several related developments also merit attention. A concern has been expressed that deregulation of the commercial transportation industries may have compromised safety, even though the government maintained safety regulation of each of these industries. The facts are otherwise. Airline accident and fatality rates continued to decline after deregulation. Truck accidents were also lower, except in one year. Rail accidents due to track defects are sharply lower. Truck and rail deregulation has contributed to a reduction of about $100 billion in the total logistics costs of American industry, about one-third due to lower freight rates and one-third to lower inventories (Barnekov 1987).

There are a number of other conditions in the airline and trucking industries, however, that should be recognized. Several airlines and many trucking firms have gone bankrupt, finding that they were unable to be competitive under their prior labor contracts. Airlines found that they could hire qualified new employees at wages up to 50 percent lower than under the labor contracts of the existing carriers. This discovery led to a rapid increase in new airlines and in wage concessions and two-tier wage systems in the older airlines. Similarly, most of the new trucking firms pay less than the union rates of the older firms. In retrospect, it is now clear that the major beneficiaries of economic regulation were neither the consumers nor the owners of regulated firms but rather the workers and managers in these firms.

[3]See *Economic Report* (1986, p. 161).

[4]On railroad deregulation, see Barnekov (1987).

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Communications

The partial deregulation of telecommunications was the result of a series of FCC decisions and a major antitrust case, without any change in legislation. Local telephone services are still regulated, but most other services have been substantially deregulated. More than 200 firms now offer long-distance telephone and data services at substantial discount below the AT&T rates, and the market for telephone equipment has expanded rapidly. The full effects of the breakups of AT&T are yet to be realized. The separation of the regional telephone companies from AT&T was expected to reduce long-distance rates and to increase local rates, and this is what happened; in the first four years following separation, real interstate rates declined about 12 percent and real local rates increased about 12 percent (Crandall 1987). These actions have also reduced the power of the communications union, leading to a reclassification of thousands of jobs to reduce average labor costs; the union has been transformed from a militant bargainer to a promoter of AT&T's long-distance services. Although these measures have been strongly supported by business users of telecommunications services, they are not to date well received by the general population.

Energy

Oil prices were first directly regulated as part of the general price and wage controls in 1971 but were unfortunately maintained when these other controls were phased out. As a consequence of the two oil shocks, these controls became increasingly burdensome. After approval of the "windfall profits" tax on domestic oil, Congress scheduled the termination of the oil price controls for September 1981. President Reagan terminated these controls immediately after his inauguration in January 1981; after a small initial increase, real oil prices have generally declined since March 1981. Within two years, domestic oil well completion was nearly 50 percent higher than in 1980, and production (exclusive of Alaska) increased slightly, reversing a 10–year trend and despite a decline in real oil prices. The energy "crisis" of the 1970s was ended by the stroke of a pen. By 1983, the administration and Congress were considering ways to maintain the domestic price of oil.

The wellhead prices of natural gas were first regulated as a consequence of a court decision in 1954. This regulation did not impose extraordinary costs until the first large increase in oil prices in 1974. Following a severe shortage of natural gas in the winter of 1977, Congress approved the Natural Gas Policy Act of 1978, legislation that was designed as a deregulation measure but was all too clever.

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The act authorized the phased decontrol of all "new" gas discovered after 1977 but maintained price controls on more than 20 categories of "old" gas. This policy would have caused only minor problems if not for the second large increase in oil prices in 1979–80. The results of the controls were somewhat surprising. Consumers did not benefit from the continued controls on the price of old gas, because delivered gas prices, after a short lag, moved in parallel with oil prices. The primary effects of the controls were to increase the margins of the pipelines and distribution companies and to reduce the production of old gas, risking the loss of old gas reserves equal to 1–3 years of consumption. The substantial decline in real oil prices in the 1980s has reduced the short-run problems of the remaining gas controls, but provides a good opportunity for their removal. A comparison of the experience with oil and gas decontrol suggests that abrupt general decontrol requires more political courage but causes far fewer problems than phased partial decontrol.

One other remnant of the energy regulations implemented in the 1970s has also been abolished. In 1987, Congress repealed the Fuel Use Act, which had prohibited utilities and industrial firms from building new boilers dependent on oil and natural gas. The repeal of this act has made it possible to add capacity in smaller increments, more quickly, and with much lower environmental effects than is possible with a coal-fired plant.

Financial Institutions

For the most part, changes in financial regulation were forced by major developments in the financial markets. Commercial and savings banks had been subject to interest rate ceilings on their deposits since the 1930s. These ceilings led to severe problems only when market interest rates increased rapidly, first in the late 1960s and again in the late 1970s. Small depositors were especially harmed by these ceilings. The development of the money market mutual funds in the 1970s offered savers deposit-like accounts with market interest rates and led to an erosion of deposits in the banking system. Congress finally responded to these developments in 1980 by approving the gradual removal of interest rate ceilings by 1986. Another law in 1982 authorized banks to offer new types of accounts to both small and large depositors. These new types of accounts proved to be very popular and were estimated to increase the interest payments to depositors by $3.6 billion a year with no significant effect on interest rates to borrowers. Other provisions of the 1982 legislation permit the acquisition of a failed bank by an out-of-state bank or by a bank of a different type.

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General Price and Wage Controls

In August 1971, President Nixon imposed general price and wage controls as part of a larger program that ended the Bretton Woods agreement on exchange rates. This was the first peacetime use of general price and wage controls in the United States. Although these controls seemed effective for a year or so, they only deferred the measured inflation. The consumer inflation rate increased from 4.3 percent in 1971 to 11 percent in 1974 as these controls were phased out (except for oil).

After the severe recession of 1974–75, the consumer inflation rate declined to 5.8 percent in 1976. A continued concern about inflation, however, led President Carter to impose a new system of "voluntary" price and wage guidelines in 1977; these guidelines were supposed to be enforced by public exposure and by denial of government contracts to those who exceeded the guidelines. Carter's guidelines proved to be no more effective, however, than Nixon's controls, and the consumer inflation rate increased to 13.5 percent in 1980.

The major lesson of this experience is that general price and wage controls are not sufficient to restrain inflation in the presence of a rapid increase in total demand. Although some politicians and economists continued to believe that the controls were valuable, President Reagan believed otherwise. Shortly after his inauguration in January 1981, Reagan abolished the price and wage guidelines and the office that monitored those guidelines. After another severe recession in 1981–82, the consumer inflation rate declined to 3.2 percent in 1983, and a moderate growth of total demand has maintained inflation at about this rate for five years. The major lesson that one should have learned from this experience is that monetary restraint is both necessary and sufficient to reduce inflation, sometimes at the expense of a temporary reduction of output. Moreover, price and wage controls, as with any form of economic regulation, reduce the general productivity of the economy. From 1973 through 1980, for example, U.S. output per hour increased at an annual rate of only 0.5 percent; since 1980, in contrast, productivity has increased at an annual rate of about 1.5 percent. Reagan's judgment on these issues proved to be correct: Inflation is best reduced by monetary restraint, not by price and wage controls, and the reduction of both inflation and regulation is likely to increase general productivity.

Unresolved Problems

Our government, unfortunately, has not yet addressed the complementary measures that are probably necessary to sustain the dereg-

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ulation of several industries. Some change in the procedures for rationing the congested airspace and airports, for example, is probably necessary to sustain airline deregulation. Similarly, some change in the procedures for rationing the frequency spectrum is probably necessary to sustain the deregulation of communications.

The most urgent problem, however, involves the financial institutions. The combination of interest rate deregulation and the current structure of deposit insurance is not viable in the long run, because banks now have an opportunity to shift more of their risks to the insurance system; some reregulation is probable unless the deposit insurance premiums or rules are changed. The total net worth of the savings banks, by commercial accounting standards, is close to zero, and this system is very vulnerable to an increase in interest rates. Bank failures continue to increase, and the current reserves of the deposit insurance agencies may be insufficient. The administration and Congress have not been willing to address the laws, almost unique to the United States, that restrict national banking or the right of banks to own or underwrite equities in nonfinancial firms.

Federal economic regulation has been substantially reduced during the past decade, but a great deal remains to be done. American agriculture is still plagued by marketing orders that limit production or set price floors on a range of products. Regulation of the frequency spectrum has inhibited the use of some communications technologies. The potential for deregulating the uses of energy, the supply of natural gas, and the production of electricity have yet to be realized. Our financial system is still cartelized by region and type of loan. Labor regulation restricts a wide range of relations that would be preferred by both employers and employees. International air travel is still subject to both price and entry regulations, railroads are subject to archaic work rules, and shipping between domestic ports is still restricted to American ships. One should recognize that many of the effects of deregulation cannot be anticipated. The general success of the economic deregulation to date, however, strengthens the case for reducing or eliminating most of the remaining types of price and entry regulations.

Some General Lessons for China

Without a specialist's understanding of China, I am cautious about offering suggestions for economic reform. Yet, in the spirit of trying to learn from each other about issues of common interest, let me summarize two general lessons from the American experience that should apply in any country: (1) As a rule, regulation is neither nec-

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essary nor sometimes sufficient to achieve the shared goals of a national community; and (2) regulation is often the most costly means to achieve these goals, both in terms of individual freedom and economic efficiency.

Let me illustrate the application of these lessons to three major goals of contemporary Chinese policy: reducing the growth of total population, maintaining a rough balance of payments, and reducing the rate of general inflation. My understanding suggests that some policy changes could achieve these goals without the restrictions on individual freedom and economic efficiency inherent in current policies.[5]

Population

As I understand, China is now attempting to reduce the growth of total population primarily by regulating the number of children per family. Effective enforcement of these regulations, by either sanctions or social pressure, is probably sufficient to meet this goal, as indicated by the sharp decline in the crude birthrate from 1970 through 1976. But such regulation is not necessary to reduce population growth. Both the long historical record and current cross-country comparisons indicate a strong negative relation between birthrates and the levels of urbanization, industrialization, and economic development. The birthrate in all of the high-income countries is now below the reproduction rate. But it is most important not to misinterpret this evidence. The most careful evaluations of this evidence indicate that *lower birthrates are a result, not a significant cause, of economic development.* The sustained economic development of China would reduce both the birthrate and death rate by different processes, and the rate of growth of total population would gradually decline without any specific policies to affect this rate.

Moreover, to an American, a limit on the number of children per family would be an intolerable restriction on individual freedom. Some rural parents may want more children because of the greater opportunity of rural children to contribute to family income. Some urban parents are surely more caring, better parents than others. As one of three sons and now the father of three daughters, my views on this issue may be biased, but children with brothers and sisters seem less "spoiled" and more prepared for adult life than are single children. In our political system, the government must bear the burden of proving that regulation of specific activities serves some

[5]The basic source for my understanding of economic conditions and policies in China is Perkins (1988).

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broader interest. There are no obvious reasons to restrict the freedom of each family to choose the number of children consistent with its own conditions and preferences.

The goal of reducing the growth of total population in China can probably be achieved by other policies that involve less restriction on the freedom of individual families. Education and the general availability of contraceptives has proven effective in reducing the number of unwanted births. Welfare programs and the tax code can be designed to influence the choice of family size. Such indirect policies can limit the total number of births without restricting the freedom of each family to make this choice. Such policies will lead some families to make mistakes in this choice. The very concept of freedom, however, means the right of an individual to make his own mistakes as long as they do not affect the rights of others.

Balance of Payments

Similarly, I understand that China is now attempting to achieve a rough balance of international payments primarily by limiting the net foreign exchange available to each firm. In effect, this limitation has required each firm to maintain its own balance of payments. The several effects of this constraint on the economy should be recognized. One effect has been to limit the opportunity of firms to specialize in either exports or imports, because each firm must earn about as much foreign exchange by exports as it uses to purchase imports. A second effect has been to limit foreign direct investment to a much lower level than was expected when the Joint Venture Law was approved. A third effect, given the large excess demand for imports, has been to strengthen the power of the bureaucracy relative to the market in the allocation of foreign exchange, with the consequent problems of favoritism and the incentives for corruption. The current controls on access to foreign exchange are probably the most important policy that limits the potential for increased integration of China into world markets.

Two types of policies would reduce the costs of these foreign exchange controls consistent with any desired level of the total balance of payments. One alternative would be to devalue the yuan. A substantial devaluation of the yuan, however, would probably be necessary to eliminate the excess demand for imports, given the extensive system of foreign quotas on products exported by China and the "soft budget constraint" on many Chinese firms. Most economists would support the relaxation or, preferably, the elimination of the many U.S. quotas on textiles, apparel, and other Chinese exports, but the near-term prospects for such changes are not encour-

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aging. The soft budget constraint on Chinese firms can best be tightened by reducing government subsidies that offset the losses of individual firms. In the absence of these changes, a major devaluation of the yuan would probably be necessary.

The only effective alternative would be policies that would increase saving by Chinese families and firms or reduce the dissaving by the government. One should recognize that the current account balance of any country is the difference between saving by residents of that country and investment in that country. China, or any country, can increase domestic investment only by increasing domestic saving or by reducing its current account balance. As long as China, for whatever reason, wishes to maintain a rough balance on its international accounts, increased investment must be financed from increased saving. The major source of potential saving, as well as the best way to tighten the soft budget constraint, may be to reduce the discretionary subsidies to Chinese firms.

Inflation

For good reasons China also wants to maintain a roughly constant general price level, but the primary policy to constrain inflation has been the control of the prices of individual goods and services. Such controls have never proved sufficient to restrain inflation for a sustained period, and they cause severe misallocations and often social unrest. In some cases, the relaxation of price controls increases the measured price indices, but that is usually a statistical illusion. Price controls increase nonprice types of rationing—by queues, favoritism, bribery, and a deterioration in the quality of goods and services. A relaxation of such controls, thus, sometimes increases measured prices but reduces these other types of rationing that are not reflected in the measured price indices.

Most of the variation of inflation in China, as in other countries, is due to an increase in the money supply relative to the level of output.[6] In the long run, monetary policy is sufficient to determine any level of general prices or the general inflation rate. In addition, it is especially important to allow increases in specific prices that would increase output, whatever their immediate effect on the measured price indices. China has ample reason to be concerned about the increased inflation rate since 1984, but the most effective response would be a combination of monetary restraint and "supply-side" economic policies to increase output, not the futile and costly reimposition of controls on specific prices.

[6]See Cheng (1987) and Chow (1987).

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Conclusion

The most important general lessons from the American experience with economic deregulation are the following:

- Deregulation was politically possible, on occasion even politically fashionable, despite the forceful opposition of some groups.
- Deregulation generated substantial benefits to consumers and substantial opportunities for new firms.
- Deregulation undermined the wage structure of some unions and the easy life of managers in the previously regulated firms.
- Deregulation led to a substantial increase in productivity in the affected industries and contributed to a general increase in productivity in the economy, creating benefits that were much larger than the losses.

The road to deregulation is not without rocks or detours, but it is the road to prosperity and opportunity. A government that represents the nation, rather than the interests of specific groups, will choose this road. Economic deregulation has been supported by the past three administrations in the United States. The increasingly confident government of China has the opportunity to choose this same road.

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Let a Billion Flowers Bloom

George Gilder

The first great rule of enterprise is do not solve problems, pursue opportunities. Problems are infinite and they multiply continuously; when you solve them, you are back where you began. Governments specialize in creating problems that they then generously solve for the people, creating yet more serious and more systemic problems in the process. The key to the success of China will be to spurn the problem solvers of the world and to pursue the supremely inviting opportunities that now exist.

The Age of Information

China now stands at the threshold of the greatest opportunity in human history: a new economic era promising greater wealth and achievement than any previous epoch. This chance to begin again is a great advantage for China, because China almost entirely missed the last economic era. The new era is the age of information, and the prime measure of the previous failure in China is the gap between the incomes of Chinese people in China and Chinese people in the rest of the world. By some measures, if the incomes of the Chinese people in China had grown just one-third as fast as the incomes of Chinese in other countries, China would be the world's largest economy and the world economy would be some 25 percent larger than it is.

Forget oil, gold, land, the ocean floor, or the reaches of outer space. The single greatest untapped resource in the world economy is the Chinese people. Many demographers and political scientists—and even the words of the Chinese language itself—treat the Chinese

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people as if they are mouths: a burden on the world's food supplies. But far more than mouths, the Chinese people are minds. The key issue of the next 25 years is whether the minds of the Chinese people in China will be emancipated on the frontiers of the new economic era.

The law of the new economy is mind over matter. A typical information product of the previous era is a book. A book is not just a paper product or a product of wood and chemical technology. A book is an information technology. That means its worth derives not from its material substance but from its informational content—not from its chemical value but from its conceptual value. A book costs about 80 cents to two dollars to manufacture in volume, but it sells for between 10 times and 100 times that amount depending on the value of the ideas it contains.

I want to present a new information technology. You cannot really see it, because it is a set of microchips in which the actual components are invisible. Microchips, now available in prototype, are the size of your thumbnail and can hold the contents of a large textbook. They will cost about the same amount as the book to mass-produce: between 80 cents and two dollars. An optical compact disk holds 600 megabytes of information—the equivalent of 600 large books. That compact disk also costs between 80 cents and two dollars to produce in volume and will sell for the value of the information it contains.

Microchips are the prime products of the new age, the key source of value in every computer and computer-related product. The substance of a microchip is mostly sand: the silicon in sand, the most common substance on the face of the earth. What matters again is not its substance but its contents: the idea, the design, the function.

So what does this mean for China? What this new technology means for China is that one of Chairman Mao's most cherished dreams can now come true. That dream can be summed up, perhaps, as power to the people. Twenty-five years ago, Chairman Mao tried to fulfill this dream by launching a program of steel mills in every backyard. This approach was very stupid. Steel mills are very bad things to have in your backyard. To function efficiently, they require huge economies of scale, involving many thousands of regimented workers.

The new microchip technology, by contrast, is based on economies of microscale. The smaller each device on the chip, the more powerful the machine. This fact means that in the information age power constantly is pulled down to individuals who command single work stations, single personal computers based on the power of the chip.

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The new economy is based not on digging into the world for valuable resources, but on designing new worlds on valueless grains of sand. A single computer work station can create value in the new economy greater than a huge steel mill. A computer work station linked to a global ganglion of satellites and fiber-optic cables can transport more value in microseconds than an entire fleet of supertankers in months.

The new technology means that Mao's dream can come true not in the backyard but on the kitchen table. For example, software programs are perhaps the most important products of the information revolution. Some 80 percent of the value of a telecommunications system comes from software and 80 percent of the value of a computer system comes from software. Even the design of a microchip itself begins as a software program. Software can be created by any individual at a work station. In the new age, power moves from the managers of large steel mills and other huge facilities to the masters of small computers.

Thus it is easily possible to fulfill Mao's dream of industrial power distributed to the people. However, to fulfill that dream absolutely requires that China abandon Mao's other dream: the dream of central planning of an economy.

The Futility of Central Planning

The law of the microcosm—the law of the microchip—is that the power of individual work stations always grows much faster than the power of large computer systems. Gone is the long dream of the socialist that giant computers will allow planners to simulate markets and thus manage large economies. The socialist dream has been confounded at the heart of the computer itself. The power of the chip always grows faster than the power of the larger system. Today's individual personal computers are more than 100 times more cost effective than large mainframe computers.

The previous technology of the industrial era to some extent favored control. By control over territory, control over natural resources, control over industrial capital, and control over taxes and trade, governments could increase the power of nations. Governments could increase national power by increasing governmental power. The new technology, on the other hand, favors freedom. It truly fosters power to the people.

Breaking the Iron Rice Bowl

Mao said: "Let a hundred flowers bloom; let a thousand thoughts contend." This showed his incomparable misunderstanding of the

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powers of the Chinese people. The rule of capitalism is "Let a billion flowers bloom; let a trillion thoughts contend." I believe that this is going to happen. We are going to have an efflorescence of entrepreneurship in China that will make China the richest economy in the world within the next 25 years.

How do I know this? Because whenever and wherever you set the Chinese free, they create new wealth. China liberated agriculture and within eight years, output tripled in rural areas and the Chinese now export rice. The new era is no different. Everywhere in the world except China the Chinese people are in the forefront of the information age. In the United States, for example, there are thousands of crucial information companies launched by Chinese entrepreneurs.

Now, however, there are exciting signs of progress in China itself. One of the fastest growing computer firms on earth was started just five years ago on a street in Beijing. "When you go out into the dark night," says Chinese entrepreneur Wan Ruttan, "the first thing you must do is throw out a stone to see where the road is." Wan Ruttan is the Communist Chinese entrepreneur who began that computer company. His "dark night" was the totalitarian murk of the economy of this so-called People's Republic.

Without market prices or consumer choices to reveal patterns of scarcity or need, an economy operates in the dark. Because no one knows what is needed in what amounts, output and demand are always mismatched, and no one produces very much. Starting a firm is pretty much a matter of throwing dice—or a stone.

Nonetheless, despite the dark shadows, Wan Ruttan hit the road hard with Stone Computer Inc. Now generating $137 million in revenues, Stone is breaking new ground in China. Within four years after its founding, Wan's firm passed all the numerous state-run computer firms to rank number one in China.

How did he do it? One young Chinese who had studied in the United States told me Wan and his ilk got rich through "greed" and "corruption." A more insightful report in *Electronic Business* magazine, however, ascribes Wan's success to his willingness, as he put it, to "break the iron rice bowl."

The "iron rice bowl" symbolizes the employment security of the Chinese: Everyone supposedly gets a job and a bowl of rice no matter how little or how ineptly he works. But in another sense, any totalitarian economy is an iron rice bowl. Designed to provide an income floor, the iron bowl always ends up imposing a rigid lid on all personal achievement and economic growth.

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Wan substituted a clay rice bowl that is "stronger than iron but breaks more easily." In other words, Wan was willing to accept risk as well as rice. Accepting risk, he also created a shocking Communist scandal: a $9.5 million after-tax profit in 1987. The fact that he was allowed to keep this money is an exciting portent for the future of China.

Everyone wants security. But if a system tries to provide security for every individual, it will create insecurity and sterility for all. The iron bowl of socialism is designed to shield the citizens from risk. But the result is to shield them from knowledge of the real dangers and opportunities in any society.

Rather than benefiting from a multiplicity of individual ventures and plans, the entire economy absorbs the much greater risk of remaining static in a dynamic world. Sooner or later, even the iron bowl is empty, and all too often it is worn as a helmet for a war of conquest or civil suppression. This cycle sums up a millennium of Chinese history.

Microstability—guaranteed jobs and incomes—comes at the cost of macroinstability: the inflexibility, weakness, and insecurity of the system as a whole. During the heyday of Maoism and the iron rice bowl guarantee, the nation's total rice production actually declined for several years. Despite all Communist claims, Harvard demographer Nick Eberstadt reports, millions of Chinese died of famine.

After the death of Mao, China began to take the lid off, allowing farmers to keep all their production and sales beyond their quota owed to the state. This system is the opposite of the iron rice bowl, a quota of food for every citizen. Instead, the state got the iron bowl—an assured quota of rice—while the farmer got freedom to keep all production beyond the quota.

In effect, the Chinese had discovered supply-side economics, imposing a zero marginal tax rate on all income beyond the government's guarantee. The result was that China began feeding itself and even exporting some rice. Output from the rural areas more than tripled, rising 246 percent according to government data. Breaking the redistributive iron bowl made China the rice bowl of the world.

The most deadly force in business life is the search for the sure thing. Only the past is ever sure. Pursuing safety first, businesses and managers end up copying the previous successes of others and often achieving obsolescence in the process. To find the road ahead—the road to future success—even in free economies, it is still necessary to throw a stone, take a risk, and break the iron bowl like Wan Ruttan.

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Stone throwers, however, are not popular in the iron bowl bureaucracies. The state-run Science and Printing Institute has threatened to sue Wan's company for alleged violation of patents. Many bureaucrats at the government computer firms are said to resent the triumph of Stone Inc. Wan told *Electronic Business:* "They claim it's my fault that nobody wants to buy their products. They would prefer it if I sold lower-quality products at higher prices."

Wan now plans to extend the reach of his risk taking to the United States. His key products are IBM-compatible word processors and printers adapted with software to use either English or Chinese characters. He also resells Unisys business computers in China. Wan believes that the increasing relations between Chinese-speaking nations and the United States and that the large number of Chinese Americans afford an opportunity to sell his products outside of China.

Indeed, Wan must know that the overseas Chinese—in Taiwan, Singapore, Hong Kong, the United States, and other countries where the iron bowl was broken decades ago—earn incomes between 25 and 55 times larger than the $300 per capita yearly earnings in the "Peoples' Republic." In fact, in nations where incomes are not guaranteed, people come to take several bowls of rice and other foods for granted. The irony is that risk taking leads to relative security and wealth for all, while the search for safety leads to totalitarian darkness at noon.

Pursue Opportunity

So my advice to Chinese reformers is, do not solve problems—inflation, corruption, trade deficits, inequality, poverty. You will just increase the power of government, weaken the power of the people, and create newer and worse problems in the process. Take the route of Wan Ruttan: Pursue opportunity.

Ruttan did not solve the problem of the 20 government computer companies that were far ahead of him when he began five years ago. He did not eliminate inflation, corruption, poverty, bureaucracy, or inequality. Instead he pursued his opportunity to create a new firm that would leap ahead of all the government companies. He did not try to liquidate the government firms or privatize them. He did not try to reform the financial system. He did not overthrow the communist cadres. He simply transcended them. Today on that same street in Beijing there are 170 other new high-technology companies and 1,000 more such companies applying for licenses. None of them will solve the systemic problems of China. But they will ultimately transform the Chinese economy by pursuing opportunity.

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I would like to conclude by telling a story about problems and opportunities. Two shoe salesmen were sent deep into the boondocks of Africa. One wired back to the home office: "Get me out of here. No one even wears shoes. There is no chance for sales." The second shoe salesman wired back: "Great opportunity! Everybody is barefoot here. Send all stock; we can dominate the market."

There are still a lot of barefoot people in China. But 25 years from today I believe that China is going to be the richest economy in the world if it pursues the opportunity of freedom and profit like Wan Ruttan. Let a billion flowers bloom!

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Deposit Insurance: A History of Failure

Clifford F. Thies and Daniel A. Gerlowski

> A deposit insurance system is like a nuclear power plant. If you build it without safety precautions, you know it's going to blow you off the face of the earth. And even if you do, you can't be sure it won't.
>
> —L. William Seidman
> Chairman, FDIC

The failures in 1985 of deposit insurance programs in Maryland and Ohio, along with the present difficulties of the Federal Savings and Loan Insurance Corporation (FSLIC) and the Federal Deposit Insurance Corporation (FDIC), have sparked a renewed debate over deposit insurance. The extensive problems among insured institutions have led academicians, policy analysts, and even some regulators to reexamine the incentives created by federal deposit insurance. In short, the existence of deposit insurance encourages depositors to choose a bank or savings and loan (S&L) institution without concerning themselves about the business practices of depository managers. This situation frees managers and stockholders to pursue greater profits through assembling portfolios that embody more risk than uninsured depositors would be willing to accept. Because the lost market discipline cannot be fully replaced by government oversight, a federally insured banking system will exhibit more risktaking than one operating without such guarantees. In the insurance industry, this phenomenon is known as "moral hazard."

This article views deposit insurance from a historical perspective and examines the record of state-sponsored deposit insurance. What emerges is a surprisingly consistent pattern: "reckless banking," losses in excess of assessments, increased assessments and borrow-

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ing, and the exit of sound banks from the insurance system, leaving an increasingly risky and ultimately uninsurable pool of remaining banks. In short, the history of deposit insurance has been disastrous. State-sponsored deposit insurance funds have all exhibited the same moral hazard problem that is evident at the federal level today.

The consistent pattern of reckless banking is explained by the perverse incentives of flat-rate deposit insurance. The only real difference between the historical state-sponsored programs and the present federal-sponsored programs is the more universal coverage provided by federal insurance. Federal programs of deposit insurance continue in the face of mounting losses due to reckless banking because sound banks are not free to exit. Thus, federal deposit insurance assessments are effectively subsidies from sound to reckless banks.

If financially sound institutions were free to leave the risk pool, these cross-subsidies would not be possible. The deposit guarantors would then suffer from what insurers call "adverse selection," in which financially sound banks would exit and an increasingly risky and ultimately uninsurable pool would bring federal deposit insurance to its conclusion.

The "Official" History

The history of deposit insurance includes two waves of experiments: the first during the early 19th century, starting with New York State's safety fund, and the second during the early 20th century, starting with Oklahoma's guaranty fund. The FDIC's annual reports for 1952, 1953, and 1956 recount this history positively. The FDIC (1952, p. 60) states that while a "majority [of deposit insurance programs] eventually proved unworkable . . . several enjoyed a moderate degree of success during their entire operation."

Specifically regarding the early 19th-century experiments, the FDIC (1953, p. 45) says these programs ceased "when the great majority of state-chartered banks became national banks," but they were not ended because of "dissatisfaction with the insurance systems."

Regarding the early 20th-century experiments, the FDIC (1956, p. 47) says, "The systems of the 1908–1930 period were considered highly successful up to the time of the bank failures associated with the depression of 1921."

Thus, the FDIC—in presenting what may be considered the "official" history of deposit insurance—presents a positive interpretation. This interpretation must be considered suspect, however, in view of the FDIC's mandate to allay concerns for bank safety.

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The Early 19th-Century Experience

The first program of deposit insurance in this country was New York's safety fund, created in 1829 (see Chaddock 1911). The purpose of this fund was to protect the bank notes of and deposits in chartered banks.[1] In the event of a bank failure, the safety fund was to cover losses of depositors and bank note holders from monies collected from insured banks through annual assessments.

The New York safety fund at first appeared successful. However, during the panic of 1837, the New York State legislature found that the safety fund "had scarcely been heard of as a means of upholding credit," and the legislature looked to the Scottish joint-stock banks for a model of bank safety (Knox 1903, pp. 398–415).

In 1842, the fund was exhausted by the failures of 11 insured banks over a three-year period. The state bank examiner identified "reckless banking" as the principal cause of failure in each of the 11 banks, including what would today be described as "insider dealing," as well as a lack of concern for safety by all involved because of the existence of the safety fund.

The City Bank of Buffalo, which was closed down in 1840, was the first of the bank failures. The state bank examiner found a record of large loans to the president and to other officers and directors of the bank, much of the proceeds of which were used to finance speculation in stocks and real estate. Furthermore, as the situation deteriorated, loans and investments of poor quality were substituted for those of good quality, leaving the safety fund with massive losses. In other failures "reckless banking" extended to criminal activity including misrepresentation, diversion of funds, and fraud.

The state legislature responded to these failures by restricting insurance coverage to bank notes and by authorizing borrowing by the safety fund. These borrowings were used to indemnify those who had already suffered losses. This debt proved the undoing of the New York insurance program. Because interest and principal on the debt had priority over new losses, the safety fund had to devote all assessment revenue to debt service for the next 20 years. Accordingly, participating banks and their note holders received little in return for their continuing assessments.

From its peak in 1837 to 1865, the number of banks participating in the New York safety fund fell from 88 (out of a total of 95) banks to only 6 (out of 284). The small number of banks remaining in the

[1]Chartered banks were those whose corporate charters were specifically approved by the state legislature. Participation in the safety fund was mandatory for approval or renewal of the charter.

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safety fund made their bank notes uninsurable. The fund closed in 1866, at which time it made good on the claims relating to past losses that were presented to it. However, because of the lapse of time since the losses were suffered, the claims that were presented probably constituted only a fraction of the losses that had been incurred.

The more popular form of banking in New York during this era proved to be "free banks." Free banks were so named because they did not require special charters from the state legislature, but could be formed by a relatively simple filing. These banks had their own set of state regulations—such as capital, collateral, and reserve requirements—but were otherwise quite competitive and successful. In particular, free banks did not participate in the safety fund. The growth of New York as a financial center was due to these free banks, and not to the chartered banks and their moribund safety fund.

New York's safety fund was imitated by Vermont in 1831 and by Michigan in 1836. Michigan's safety fund collapsed almost immediately under the strains of the Panic of 1837 with no funds available to cover losses. Vermont's safety fund failed in an experience that closely paralleled that of New York. In Vermont, the number of insured chartered banks fell from 13 (out of a total of 18 banks) during 1841–48 to 0 (out of 41) in 1859. Of the losses suffered under this system, only two-thirds were made good by the safety fund.[2]

The Early 20th-Century Experience

From 1908 to 1917 eight states passed deposit guaranty legislation. These included Oklahoma, Kansas, Nebraska, Texas, Mississippi, South Dakota, North Dakota, and Washington. All eight guaranty funds failed during the 1920s, starting with Washington's fund in 1921. Of the eight, all but the Texas guaranty fund left depositors with uninsured losses.

Thomas B. Robb, in *The Guaranty of Bank Deposits* (1921), attributes these guaranty funds to granger agitation (see also Cooke 1923). In particular, he describes Oklahoma, which passed the first of the guaranty fund laws, as "the land of sanguine radicalism and experimental legislation," where " 'a law against it' is the specific for every malady" (Robb 1921, p. 6).

During its first legislative session in 1907, the new state of Oklahoma established a guaranty fund through assessments on state char-

[2]For a review of the state banks of Indiana, Iowa, and Ohio, see FDIC (1952, 1953, and 1956). These state banks, which were confederations of unit banks (referred to as "branches") were effectively monopoly banks and are considerably different from other banking systems (see Preston 1922, pp. 83–125; and Erickson 1971, pp. 95–116).

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tered banks as opposed to federally chartered or national banks), which was to make good the losses of depositors in failed banks.

Almost immediately the fund was in jeopardy as Columbia Bank and Trust Company, the largest in Oklahoma, failed in September 1909. This bank had, in less than one year, expanded its deposits almost eight-fold, from $365,000 to $2.8 million, under the protection of the guaranty fund. These funds were, in turn, lent to real estate and oil speculators, including officers of the bank. The person who controlled the Columbia Bank was also involved in other bank failures, including Farmers National Bank of Tulsa that was closed in December 1909 (see Cooke 1911).

The governor took personal charge of the guaranty fund, securing cash by wire for disbursement to small depositors in order to prevent runs on other banks, while making large depositors accept payment in the impaired mortgages of the failed Columbia Bank. This and other failures forced the legislature to impose additional assessments on the remaining banks as well as to authorize borrowing by the guaranty fund.

Initially, the ability to offer insured deposits to the public was attractive to banks, and several national banks rechartered as state banks in order to join the guaranty fund. But as the reality of rising assessments set in, more and more state banks—especially the larger and more financially sound ones—rechartered as national banks.

As a result of this trend, the remaining banks of the guaranty fund constituted an increasingly risky pool, requiring increasingly higher assessments, which increased the incentives for the remaining financially sound banks to leave by rechartering as national banks.

From 1913 to 1923 the number of state banks in Oklahoma dropped from 596 to 443, while the number of national banks increased from 326 to 457. The number of failures among state banks totaled 121, while those of national banks totaled only 10.

Figures 1 through 6 illustrate the effects of the guaranty fund on banking in Oklahoma.[3] Figures 1 and 2 show that the guaranty fund initially led to increases in the number of state banks and their deposits relative to national banks. However, after just a few years, and after reckless banking had resulted in several bank failures, the number of state banks and their deposits fell relative to their national counterparts.

Figures 3 and 4 illustrate the effects of the guaranty fund on the liquidity and capitalization of state banks. Figure 3 shows that, prior

[3]Figures 1–6 are based on data drawn from the Federal Reserve's *All Banking Statistics* (1956).

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FIGURE 1

NUMBER OF BANKS IN OKLAHOMA, 1906–15

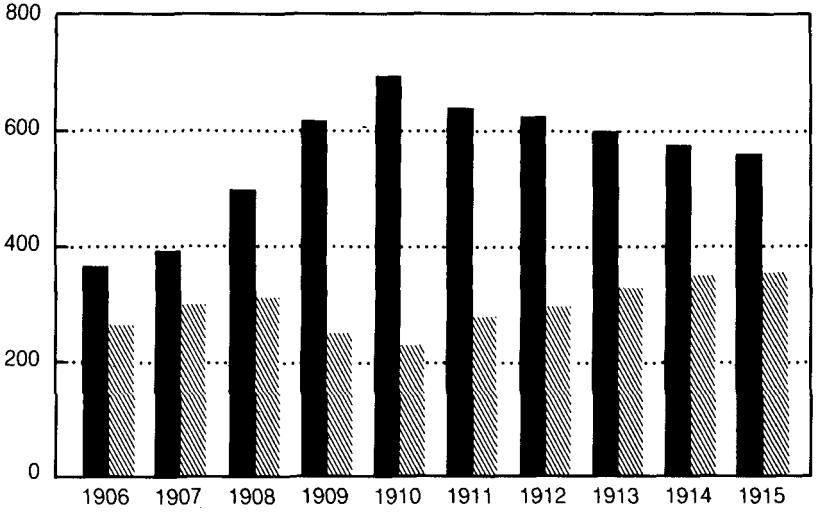

FIGURE 2

BANK DEPOSITS IN OKLAHOMA, 1906–15

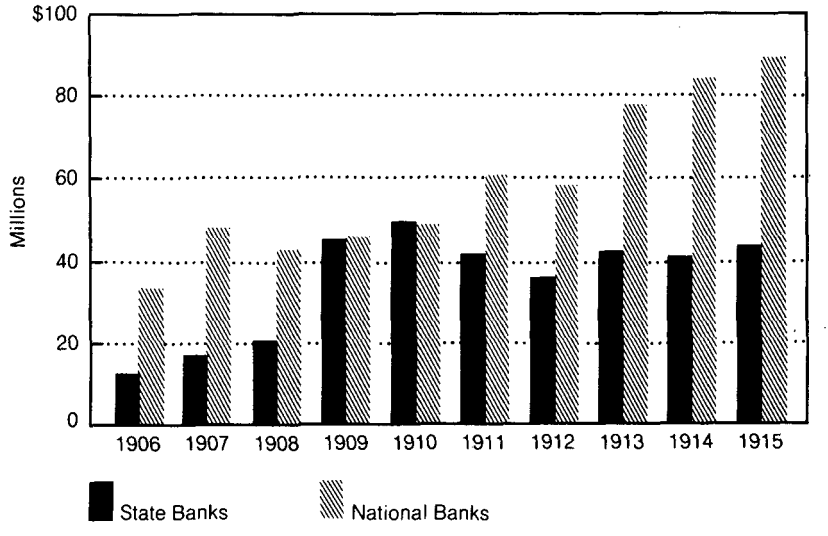

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FIGURE 3

LIQUIDITY RATIO IN OKLAHOMA BANKS, 1906–15

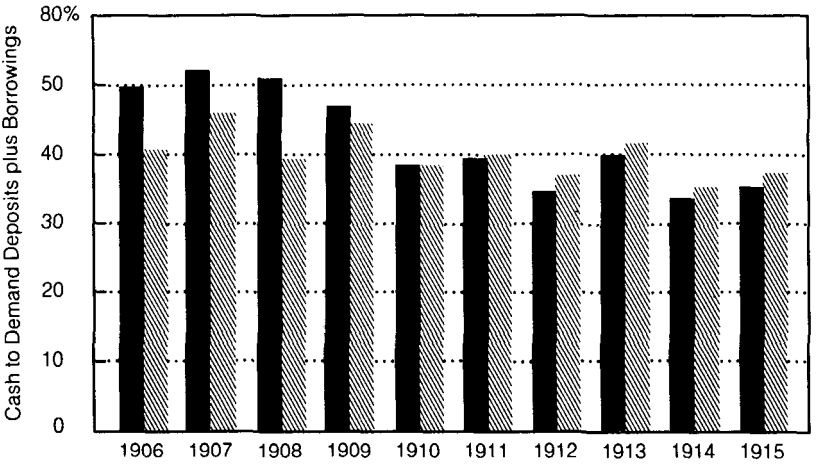

FIGURE 4

CAPITALIZATION RATIO FOR OKLAHOMA BANKS, 1906–15

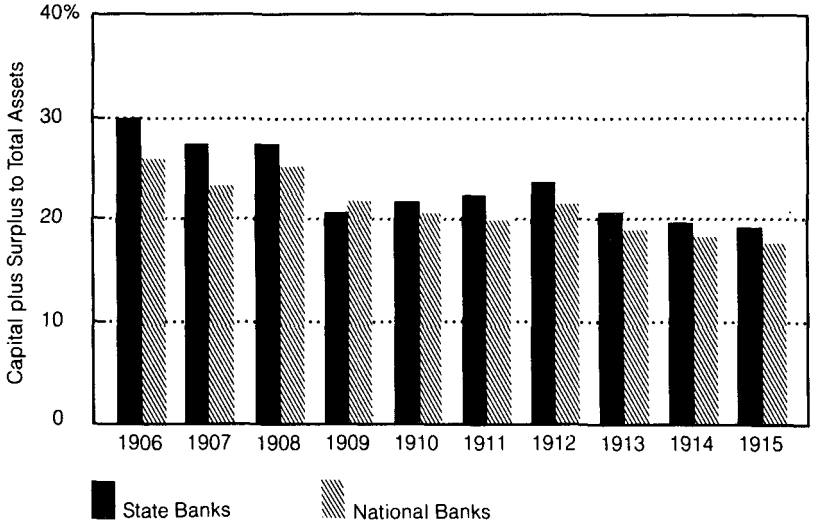

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FIGURE 5

RATIO OF REAL ESTATE LOANS TO TOTAL ASSETS IN OKLAHOMA BANKS, 1906–15

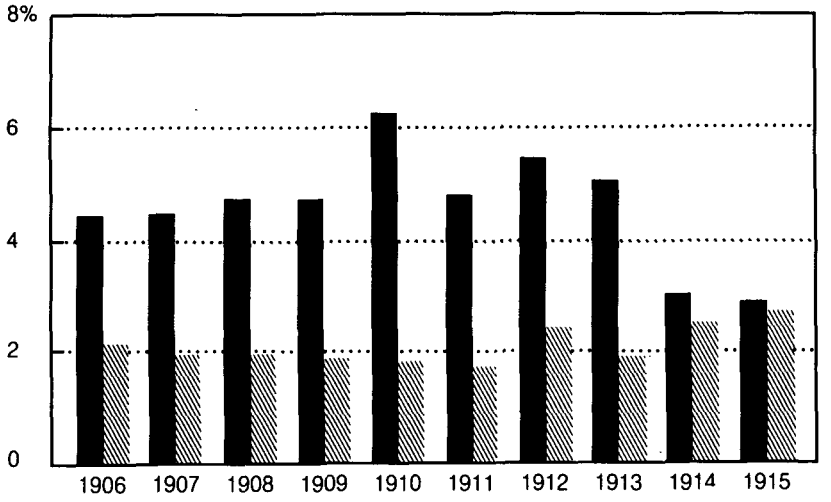
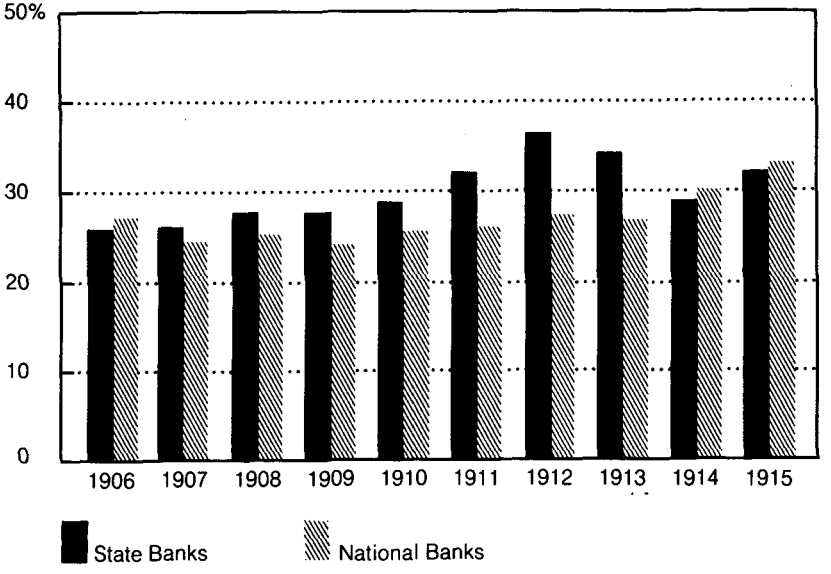


FIGURE 6

RATIO OF COLLATERAL LOANS TO TOTAL ASSETS IN OKLAHOMA BANKS, 1906–15



SOURCE: *All Bank Statistics* (1956).

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to the guaranty fund, state banks had greater liquidity than national banks. This difference is understandable since state banks were generally smaller and probably needed greater liquidity to attract deposits in a competitive market. However, with the guaranty fund and in spite of their smaller size, state banks could operate with less liquidity than national banks. Figure 4 shows that, both before and after the guaranty fund, state banks maintained slightly higher capitalization ratios than national banks. However, in 1909, the first full year of the guaranty fund, state bank capitalization fell relative to national bank capitalization.

Figures 5 and 6 illustrate the effects of the guaranty fund on the risk characteristics of the assets of state banks. Figure 5 shows that, with the guaranty fund, state banks greatly expanded their real estate loan portfolios. Figure 6 shows that state bank lending on collateral experienced a similar although less-marked trend.

Figures 3 through 6 clearly demonstrate that the guaranty fund led state banks to undertake increased risks. These aggregate trends probably understate what was happening on a selected individual bank basis. While the majority of state banks may have continued with business as usual, and thus muted the overall trends, certain banks undoubtedly used the guaranty fund to engage in reckless banking.

While increased risktaking became evident after the first few years of the Oklahoma guaranty fund, by 1923 the fund's situation had become untenable. Interest alone on the outstanding debt of the fund equaled the annual assessment, meaning that the fund had no income or unused borrowing capacity to make good on additional losses. Claiming that "state honor" was at stake, some politicians argued for an increase in assessments or state assumption of the debts of the guaranty fund. However, the legislature simply allowed the fund to go bankrupt, leaving some $3 million in depositor losses uncovered.

Other States

Washington's guaranty fund collapsed under the failure of the largest bank in its system, the Scandinavian-American Bank of Seattle. Losses associated with this failure consumed the entire fund as well as a special assessment that was levied. Rather than continue to exact high assessments on banks remaining with the fund, the legislature repealed its deposit guaranty law. This action left depositors with 75 cents on the dollar from liquidation of the assets of the Scandinavian-American Bank and only 10 cents from the guaranty fund.

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In Texas the guaranty fund was at first viewed quite favorably by bankers. With typical Texan hyperbole, the secretary of the Texas Bankers Association boasted in 1920 that "the guaranty fund was the greatest piece of constructive legislation ever enacted in the country."

In just a few years, with assessments running at the legal maximum in order to cover a growing number of losses, Texas banks left the guaranty fund in droves. From 1924 to 1926, the number of eligible participating banks fell from 896 to 34, and the number of eligible nonparticipating banks increased from 37 to 748. By 1926 the guaranty fund was exhausted. Failures by nine of the small number of remaining participating banks forced the legislature to repeal the deposit guaranty law and liquidate the fund.

In South Dakota, 16 bank failures nearly exhausted the guaranty fund in 1923. Depositors at the seventeenth bank to fail that year were paid half in cash and half in certificates of indebtedness. Even though assessments continued to be levied, losses on subsequent bank failures were covered only by certificates. In 1927, the deposit guaranty law was repealed and the fund liquidated. Liquidation of the fund enabled two payments on the certificates that, combined, amounted to about 1 percent of their face value.

In Kansas, the 1923 failure of the American State Bank of Wichita, the third largest bank in the system, embarrassed a guaranty fund already deep in debt. Interest on the fund's outstanding debt plus interest on the debt expected to be incurred to make good on losses at the American State Bank approximated revenue from assessments, meaning no money would be available to cover future losses. This situation led to a massive exodus of banks from the system and left a remaining risk pool of banks that were uninsurable. When the guaranty law was repealed in 1929, depositors of 88 failed banks were left with nothing.

In Kansas failure rates among banks associated with the guaranty fund exceeded failure rates experienced by nonparticipating banks. From 1919 to 1923, 33 failures occurred among participating state banks, which represented 5 percent of the 691 participating state banks in 1923. In contrast, eight failures occurred among nonparticipating state banks, or 2 percent of the 381 nonparticipating state banks in 1923, and no failures occurred among the 266 national banks.

North Dakota exhausted its guaranty fund in 1920, whereupon it began paying depositors 10 percent in cash from assessments and 90 percent in certificates of deposit. Soon thereafter the guaranty fund ended payments of any kind. By 1929 it became obvious that the fund would never be solvent, and the law was repealed. Depositors at 201 failed banks recovered 10 percent of their deposits, and depos-

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itors at another 137 received nothing until 1937, at which time they were paid 1 percent.

In Nebraska the guaranty fund often made good on the losses of depositors by taking over and operating failed banks. Through 1920 this action appeared to protect deposits. However, by that time, losses on state-run banks threatened the solvency of the fund. Accordingly, the fund started to liquidate the banks it was operating and soon ran out of money to pay depositors.

In 1930 the Nebraska deposit guaranty law was repealed, and the past losses of depositors were supposed to be paid through a bond issue and continuing assessments on banks. Voters rejected the bond issue, and the state supreme court rejected continuing assessments as "confiscatory" since no insurance would be provided. This move left depositors at 24 failed banks with only partial recovery and at 164 others with no recovery at all.

For failed banks in Mississippi the guaranty fund issued certificates of indebtedness at an early point to cover the depositors' losses, which were outstripping assessment revenues. As the debt of the guaranty fund piled up, new certificates were no longer marketable. In 1930 the deposit guaranty law was repealed, and the outstanding certificates were paid off by continuing assessments through 1934 and by general tax revenue thereafter.

Analyzing the Data

In its review of the early 20th-century guaranty funds, the FDIC (1956, p. 64) stated: "It is easy to place more stress than is warranted on the presumption that deposit insurance itself led to ill-considered expansion and reckless management." The FDIC did admit that deposit insurance engendered rapid expansions in the number of state banks, as well as in their total deposits and loan portfolios of participating banks, and that inadequate attention was given to loan quality. But other "more fundamental underlying factors" were cited to explain the large number of state bank failures in states with guaranty funds.

Key to the FDIC's argument is that state bank failure rates in some of the states with guaranty funds were lower than in some contiguous states without such funds. The obvious statistical flaw with this argument is the nonrandom selection of test and control states. That is, the FDIC selected only those states with guaranty funds and those contiguous states without guaranty funds whose experience supported its argument.

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In order to investigate the validity of the FDIC's claim, we gathered and analyzed the available data on bank failures. When the data are analyzed in a statistically valid way, deposit insurance is found to increase—rather than reduce—bank failures.

Two sources provided the bulk of the data used in our analysis: *All Bank Statistics*, published by the Federal Reserve Board in 1956, which gives detailed information on the number of states and national banks and their balance sheets on an annual basis from 1896 to 1955; and *Banking and Monetary Statistics*, published by the Federal Reserve Board in 1943, which gives complementary information on bank failures from 1921 to 1941. The beginning date of the information on bank failures, 1921, marks the initial year of the analysis. The ending date, 1929, is chosen in order to avoid complications arising from the bank panics of the Great Depression.

The effect of deposit insurance on two measures of bank failure was estimated, while controlling for time, region, and urbanization.[4] These two measures are the bank failure rate (that is, state bank failures as a percentage of all state banks) and the deposit failure rate (that is, deposits in failing state banks as a percentage of deposits in all state banks).

Other things equal, state banks in states with guaranty funds failed at a higher rate than state banks in states without guaranty funds. Guaranty funds raised the annual failure rate of state banks by 0.7 percentage points. (This estimate is significant at the two-tailed, 10 percent level.) Other things equal, deposits in state banks in states with guaranty funds failed at a higher rate than deposits in state banks in states without guaranty funds. Guaranty funds raised the annual failure rate of deposits in state banks by 1.9 percentage points. (This estimate is significant at the two-tailed, 5 percent level.)

The guaranty funds had a larger effect on the state bank deposit failure rate than on the state bank failure rate. This fact probably indicates that the guaranty funds encouraged unsound growth among selected state banks, which led to their failure.

As a check on the validity of this analysis, the same methodology was applied to national bank failures. Since national banks did not participate in state guaranty funds, the existence or nonexistence of these funds should not have affected national bank failures. On the other hand, if the estimated effects of deposit insurance on state bank failures are due to misspecification (for example, if some other state- or region-specific event accounted for the higher failure rate in states with guaranty funds), then similar results should be obtained in

[4]The full set of results is available on request from the authors.

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analysis of national bank failures. In fact, the existence of guaranty funds proved statistically insignificant in explaining analogous measures of national bank failures.

While other "underlying factors" undoubtedly contributed to the high rate of bank failures during the 1920s, careful analysis demonstrates that guaranty funds exacerbated, instead of reduced, the problem.

Current Problems

The pattern of deposit insurance system failures has recently reappeared. In 1983, with the failure of Commonwealth Savings Co., the Nebraska Depository Institutions Guaranty Corporation collapsed. The president of Commonwealth Savings was later sent to prison for criminal activity connected with his bank's failure.

In 1985, in conjunction with the E.S.M. Government Securities scandal in which U.S. Treasury securities were simultaneously sold and used for loan collateral, Home State Savings and Loan failed and took with it the Ohio deposit insurance program.

Also in 1985, insider dealing, diversion of funds, deceptive accounting practices, and other violations of law at Old Court Savings and Loan, as well as growing depositor concerns for the safety of Maryland savings and loans and their insurance program, led to failure of the state's deposit insurance program. Here as in Nebraska the bank president involved was later sent to prison.

These three recent failures of state deposit insurance programs reveal the perverse incentives and lack of concern over risktaking—in short, the "reckless banking"—that characterize flat-rate deposit insurance. Federal deposit insurance programs also exhibit the pattern observed time and again with state programs, although the nearly universal coverage of the federal programs has delayed their failure.

The critical year for the Federal Savings and Loan Insurance Corporation was 1982. In that year, the FSLIC closed 252 thrift institutions, a post-1933 record. However, because of limited cash and personnel, another 201 *insolvent* thrifts were left open. Capital requirements, which are supposed to induce risk-averse behavior and to act as a buffer against unexpected losses, no longer protected the FSLIC. With negative net worth but with continued deposit insurance, the owners and managers of these "zombie" thrifts had a strong incentive to increase their risk exposure. In 1983 and 1984, the FSLIC closed fewer and fewer thrifts, and the number of insolvent but still open "zombie" thrifts rose to over 400 (Brumbaugh and Carron 1987, p. 357).

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According to the General Accounting Office (GAO 1986) continuing losses at weak savings and loans threatened the solvency of the FSLIC. Against an estimate of $24 billion in unrealized losses, the FSLIC had reserves of only about $6 billion.[5] Continuing cash flow considerations and even political pressure inhibited the closing of impaired thrifts.

In 1987, the Congress passed a "recapitalization" plan that allowed the FSLIC to borrow up to $10.8 billion through a shell corporation. Through August 1988, $8.4 billion of this authority had already been used in reorganizing thrift institutions.

Included among the reorganized thrifts are three Texan high-flyers: Sunbelt Savings Association of Texas, Western Federal Savings and Loan Association, and Independent Savings and Loan Association, whose owners and managers have been removed and barred from the industry and are awaiting criminal investigation for alleged bank fraud and other misdeeds. These savings and loans were notorious for insider lending as well as for making "back-scratching" loan deals among themselves.

A study conducted by the House Government Operations Committee found misconduct in 168 of 210 thrift insolvencies and 98 of 354 bank failures during the three and a half years ending in June 1987. As of June 1988, there were 7,350 bank and thrift cases under investigation by the FBI and federal grand juries ("Misconduct" 1988). Probably the single most outrageous case of reckless banking is that of Vernon Savings and Loan of Texas. When seized by federal authorities in 1987, 96 percent of its $1.3 billion in loans were in default. Even worse, a delay in the FSLIC's taking over of Vernon caused by the political intervention of House Speaker Jim Wright, allowed the institution to lend an additional $300 million, all of which appears to be lost.

Estimates of the ultimate cost of thrift reorganizations have been ballooning since the recapitalization was passed. In May 1988, the GAO projected that $26 to $36 billion would be required to restore solvency to failing federally insured S&Ls ("GAO Projects" 1988). In Congressional testimony during July, M. Danny Wall, chairman of the Federal Home Loan Bank Board, estimated that $42.5 billion would be needed by the FSLIC through the next decade to deal with the thrift crisis ("Bank Board" 1988). During August, L. William Seidman, chairman of the FDIC, told Congress that $50 billion would be required ("FDIC Chief" 1988).

[5]At the end of 1987, the FSLIC's reserves had fallen to negative $13 billion.

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Due to its massive losses, the FSLIC has added special assessments of ⅛ of 1 percent of deposits to its regular annual insurance premium of 1/12 of 1 percent. These high assessments are scheduled to continue even under optimistic forecasts of reduced future losses in order to repay the funds borrowed through the recapitalization program. At this time, interest alone on the FSLIC's outstanding debt approximates its total assessment revenue.

Because of the high assessments, some healthy thrifts departed the FSLIC and obtained insurance from the FDIC. Although the actual number of switches was small, applications with the FDIC were increasing. An exodus of healthy thrifts could result in a fund dominated by bad risks. "No insurance system can survive like that," said John Morgan, who is chairman of the National Council of Savings Institutions.[6] To discourage switching, the FSLIC instituted an exit fee of twice the previous year's assessment, and a temporary ban on withdrawals was included in the 1987 legislation. In 1988, Congress voted to extend this ban.

About one in three thrift institutions have the 6 percent capital-to-assets ratio required to qualify for FDIC membership. Many of these thrifts are likely to opt for the alternative federal deposit insurer upon expiration of the ban on withdrawals from the FSLIC. If sound thrifts start switching, the FSLIC will soon collapse.

Thus, the same historical pattern of perverse incentives leading to losses in excess of assessments, leading to increases in assessments and to borrowing to meet immediate needs, leading to departures of healthy financial institutions and an increasingly risky pool of insureds is becoming evident at the FSLIC. At this time the only break with this pattern is due to the legislative ban on withdrawals.

Once this pattern emerged with state deposit insurance programs, the situation quickly deteriorated to its predictable conclusion. Things are different for two reasons with federal deposit insurance. First, it is more difficult to leave. As a result, flat-rate assessments can be used to a greater extent as a cross-subsidy, and rising premiums can be imposed on prudent financial institutions to protect the depositors of those institutions that take undue risks. Second, federal deposit insurers are backed, at least implicitly, by the U.S. Treasury and the Federal Reserve. These differences have postponed the FSLIC's demise and have allowed it to become a calamity of tremendously large proportion, dwarfing the failures of state deposit insurance programs.

[6]Quoted in "Some Major Thrifts" (1987, p. 6).

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Even the FDIC, considered up to now to be financially strong, is showing signs of strain. Bailouts of several large Texas banks during 1988 absorbed much of the FDIC's reserves, perhaps $5 billion against reserves of $18 billion at the end of 1987. Remaining reserves could easily be wiped out by bank failures during a recession or a surge in interest rates.

The ability today of federal deposit insurers to increase insurance assessments on sound financial institutions, and so subsidize risk-taking financial institutions, is limited. Money market mutual funds, repo's and eurodollars drain monies out of deposit accounts and, thus, lower potential assessment revenue. At the end of 1987 money market mutual funds, repo's, and eurodollars included in the Federal Reserve's M2 figure totaled $1.6 trillion. These "unassessable" sources of liquidity were fully 57 percent of the $2.8 trillion total of demand, savings, and time deposits at banks and thrifts.

Increases in deposit insurance premiums could be expected to shift additional funds to these sources of liquidity lying outside the banking industry. Taking these financial innovations into account, deposit insurance is a particularly regressive tax, falling disproportionately on small and unsophisticated depositers who do not take advantage of these innovations for the benefit of free-wheeling, reckless bankers.

While the Congress could still act to fundamentally reform federal deposit insurance, history demonstrates that legislatures do not act during the "gathering crisis in deposit insurance" to prevent the crisis through reform.[7] Deposit insurance programs are not reformed; they fail.

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Budget Deficits and Constitutional Constraints

Antonio Martino

Introduction

Budget deficits were regarded as the ultimate propellant of economic growth when, under the influence of the "Keynesian revolution," most economists believed that high employment and stability could be achieved through appropriate manipulations of the budget. In recent times, however, we have witnessed a reversal in the profession's conventional wisdom. Deficits are now being blamed for a lot of different economic problems: inflation, unemployment, slow growth, the stock market crash, high interest rates, balance of payments difficulties, instability of exchange rates, and a variety of other troubles.

While some of these criticisms are dubious or definitely unfounded, it is increasingly recognized that, whereas deficit-financed increases in public spending change the *structure* of total spending, by transferring funds from the private to the public sector, their impact on the *level* of aggregate demand may very well be negligible in most cases.

Be that as it may, what follows will be devoted to examining the following three theses:

1. Budget deficits make government growth easier. The possibility of running a deficit allows politicians to hide the cost of government from those who bear it.
2. Paradoxically, under different circumstances, the preoccupation with the size of the deficit may slow down the growth of spending. According to Professor Milton Friedman (1987, 1988), this is the case in the United States today. I maintain, however,

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that in the long run the "Friedman effect" is less important in slowing down spending growth than financial illusion is in accelerating it.

3. While Constitutional constraints may ultimately prove ineffective, they are probably all we can hope for to (temporarily?) halt or slow down the increase in public sector spending.

In analyzing these issues, I shall mostly draw on my country's experience. I am convinced, however, that the conclusions are not idiosyncratic in that they are broadly applicable to a variety of other countries. Italy seems to be the ideal candidate for the study of government deficits both because it ranks as number one among Western advanced democracies in terms of the deficit to GDP ratio, and because it has an admirable fiscal Constitution that was intended to make the formation of budget deficits almost impossible.

The Problem

The single most significant feature of Italy's economy in the past 25 years is the growth of government spending, taxation, and budget deficits. In fact, Italy's problem is an extreme variation of a more general theme: "Public spending in the 24 industrial countries belonging to the Organization for Economic Co-operation and Development (OECD) is now about 43 percent of their gross domestic products. In 1960 . . . the ratio was only 29 percent." And, "in all industrial countries, taxes have risen as a proportion of GDP since 1965" (*The Economist*, 1 June 1985).

Spending

From 1960 to 1987 public sector spending has increased 68 times in nominal terms, 489 percent in real terms (taking inflation into account), and it has gone from 32.7 percent of GDP to 52.2 percent. The process tends to accelerate: From 1980 to 1987 public sector spending has increased 204 percent in nominal terms or 42.3 percent in real terms, and it has gone from 43.2 percent of GDP to 52.2 percent (see Table 1).

From 1980 to 1987 the increase in public sector spending has absorbed 58.2 percent of the increase in GDP: For every million lire of additional product, 582,000 lire have gone to the government and 418,000 lire have been left to the private sector. It is worth noting that this spectacular increase has taken place at a time when all governments were giving the control of spending top priority in their programs. The results of their efforts have been disappointing, to say the least. Had spending remained constant in nominal terms from

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TABLE 1

PUBLIC SECTOR SPENDING IN ITALY

	Billions of Lire		
	Current Prices	1987 Prices	Percent of GDP
1960	7,588	87,181	32.7
1965	14,581	132,032	37.3
1970	22,816	177,948	36.3
1975	57,816	263,439	46.1
1980	168,811	360,749	43.2
1985	431,183	477,429	52.9
1987	513,351	513,351	52.2

SOURCE: Based on data from Banca d'Italia, 1988.

TABLE 2

TAX REVENUE AS A PERCENTAGE OF GDP, 1982–84 AVERAGE

Country	Average Tax Rate (%)
France	44.61
Italy	40.72
United Kingdom	38.56
Germany	37.57
Canada	33.61
United States	29.52
Japan	27.08
"G–7" Average	35.95
OECD	36.87

SOURCE: Peleggi (1987, p. 14).

1980 to 1987, in 1987 the budget would have shown a *surplus* of 238,084 billion lire; had it remained constant in real terms, the budget would still have had a *surplus* of 46,145 billion lire. Finally, had spending grown in proportion to GDP, net borrowing in 1987 would have amounted to 17,979 lire instead of 106,456 billion lire.

Taxation

Contrary to popular mythology, Italy is a heavily taxed country. Italians may be ingenious tax evaders, but they end up paying more explicit taxes than taxpayers of other Western countries.

International comparisons are always difficult to make. However, this should not discourage us from making them. The figures in Table 2 should not be taken at face value; even with all caveats, however,

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they show how much more serious the problem of excessive taxation is in Italy compared with the other six members of the so-called Group of Seven (G–7) and the average for OECD countries.

It is also interesting to note that the only country in which tax revenue as a percentage of GDP exceeds Italy's—France—is in the process of revising its GDP figures upward, so that Italy may soon achieve the dubious honor of being the most heavily taxed country in the G–7.

In addition to international comparisons, which are inevitably debatable, the severity of taxation in Italy is shown by the rapid growth of taxes over time. The figures in Table 3 show the rapid growth of public sector revenue since 1975. From 1975 to 1987 total revenue has increased more than nine-fold in nominal terms or over 110 percent in real terms, and it has gone from 33.6 percent to 41.4 percent of GDP. The increase has been particularly exorbitant in income tax revenue: From 1975 to 1987, it increased almost 16 times in nominal terms or three and a half times in real terms, and the percentage of public spending it finances has gone from 14.6 percent to 26.7 percent. Finally, as for marginal rates, Italian taxpayers start facing a 26 percent marginal rate at an annual income of U.S. $8,500.

Marginal Propensity for Public Sector Spending

The figures on public spending and revenue allow us to analyze the relationship between the two. Specifically, how public spending

TABLE 3

TOTAL PUBLIC SECTOR REVENUE IN ITALY

	Billions of Lire		
	Current Prices	1987 Prices	Percent of GDP
1975	42,159	192,098	33.63
1976	55,778	217,514	35.61
1977	70,596	235,357	37.14
1978	85,454	253,985	38.45
1979	102,567	265,680	37.96
1980	134,315	287,031	34.40
1981	168,007	300,444	35.90
1982	209,308	321,330	38.40
1983	257,463	344,952	40.64
1984	288,793	349,067	39.68
1985	326,757	361,803	40.06
1986	369,031	386,010	40.90
1987	406,895	406,895	41.41

SOURCE: Based on data from Banca d'Italia, 1988.

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reacts to increases in revenue deserves investigation. The reason is obvious: From an ex post perspective, it is an arithmetic truism that if revenue increases while spending remains constant, the deficit is reduced. What is true ex post need not be true ex ante: An increase in revenue compared to last year's need not reduce the deficit if in the meantime spending also increases. The net effect of an increase in revenue on the size of the deficit obviously depends on the size of the spending increase compared to the magnitude of the increase in revenue.

Borrowing a somewhat different Keynesian concept, what matters is the "marginal propensity for public sector spending," the ratio of the increase in total government spending to the increase in tax revenue. This propensity is shown in Table 4 for the period 1975–87. The figures show that the marginal propensity for public sector spending has been greater than one in every year except 1976 and 1986, averaging 1.3123 for the entire period: A 1,000,000 lire increase in revenue has on average resulted in a 1,312,300 lire increase in spending, and a consequent 312,300 lire increase in net borrowing. It further means that, even though revenue has increased every year, this has not resulted in a reduction of the deficit, because, with the exception of 1976 and 1986, the increase in revenue has always stimulated an even larger increase in spending.

TABLE 4

ITALY'S MARGINAL PROPENSITY FOR PUBLIC SECTOR SPENDING

	dG	dT	dG/dT
1975	12,078	5,740	2.10
1976	13,195	13,619	0.97
1977	16,197	14,818	1.09
1978	21,843	14,858	1.47
1979	20,897	17,113	1.22
1980	38,863	31,748	1.22
1981	53,237	33,692	1.58
1982	51,021	41,301	1.24
1983	54,540	48,155	1.13
1984	46,628	31,330	1.49
1985	56,946	37,964	1.50
1986	41,669	42,274	0.98
1987	40,499	37,864	1.07

NOTE: dG = increase in public sector spending, billions of lire; dT = increase in public sector revenue, billions of lire; dG/dT = "government's marginal propensity to spend."
SOURCE: Based on data from Banca d'Italia, 1988.

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As for the two exceptions, in those two years Italy's marginal propensity for public sector spending was 0.97 and 0.98, respectively. This means that in 1976 and 1986 the increase in revenue has in fact resulted in a reduction in the deficit. However, a deficit reduction of 20 to 30 thousand lire has cost the Italian taxpayer one million lire. In the light of the evidence, increasing public revenue through higher taxation does not seem a very effective way to cut the deficit.

The Deficit

The most spectacular increase has been that of the deficit. From 1961 to 1987 the deficit (in the IMF definition) has increased 319 times in nominal terms or over 28 times in real terms, and it has gone from 1.4 percent of GDP in 1961 to 11.6 percent in 1987 (see Table 5).

To get an idea of the size of Italy's deficit, we can compare it to the U.S. deficit. In 1985 the U.S. deficit (in the IMF definition) reached a staggering $212.11 billion. Had the federal government run a deficit equal, in proportion to the country's GDP, to that of the Italian government, it would have reached $597.5 billion. This means that, in relative terms, the Italian deficit in 1985 was almost three times larger than the U.S. federal budget deficit. And this is an understatement because in America the total public sector deficit is smaller than that of the federal government (as some state and local governments run budget surpluses).

According to the data in Table 6, the magnitude of Italy's public sector deficit is substantially higher than that of any other country in

TABLE 5

ITALIAN GOVERNMENT DEFICIT

	Billions of Lire			
	Current Prices	1987 Prices	GDP	Percent of Total Public Sector Spending
1951	388	5,315	3.74	n.a.
1956	330	4,030	2.02	n.a.
1961	357	4,015	1.38	4.10
1966	1,831	16,169	4.32	11.81
1971	4,757	35,298	6.94	16.77
1976	14,866	57,972	9.49	20.93
1981	53,296	95,308	11.39	24.00
1986	108,497	113,489	12.02	22.94
1987	113,899	113,899	11.59	22.19

SOURCES: For the deficit and the CPI: International Monetary Fund, *International Financial Statistics*, various issues. For GDP and public sector spending: Banca d'Italia.

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TABLE 6

GOVERNMENT DEFICIT AS A PERCENTAGE OF GDP, 1987

Country	Deficit as Percentage of GDP
Italy	12.6
Canada	4.9
France	2.7
United Kingdom	2.7
United States	2.4
Germany	1.5
Japan	0.9

SOURCE: Roberts (1987, p. 5).

the G–7. Although the table refers to 1987, updating the table does not change Italy's position as the leading deficit nation in the G–7.

The relationship between the deficit and government spending is illustrated in Figures 1 through 4. In real per capita terms, the cost of government in Italy has increased from U.S. $1,410 in 1960 to U.S. $6,986 in 1987 (Figure 1). The time pattern of the deficit has been remarkably similar to that of total spending both in absolute terms (Figure 2) and as a percentage of GDP (Figure 3). Finally, the deficit as a percentage of total spending has fluctuated along a rising trend (Figure 4).

Public Debt

Not surprisingly, the need to finance growing annual deficits has resulted in the rapid increase of total public debt outstanding.

The figures in Table 7 illustrate the growth of public debt. As in the case of the deficit (see Table 5), total debt was reduced as a percentage of GDP until the mid-1960s. From then on it started to grow rapidly: In 1987 it was 68 times larger than in 1965 in nominal terms, and over 7 times in real terms. During the same period, public debt rose from 34.2 percent to 92.4 percent of GDP. According to a recent government paper, the correct ratio for 1987 is 97.2 percent, and it is supposed to rise to 120.7 percent by 1992. Per capita public debt in real terms (1987 prices) has risen from U.S. $1,954 in 1966 to U.S. $12,798 in 1987 (see Figure 5).

The deficit has also been a source of difficulties (and a scapegoat) for the monetary authorities, who are always prepared to blame the rapid rate of monetary growth on the size of the budget deficit. While in general monetary growth has been closely related to the increase

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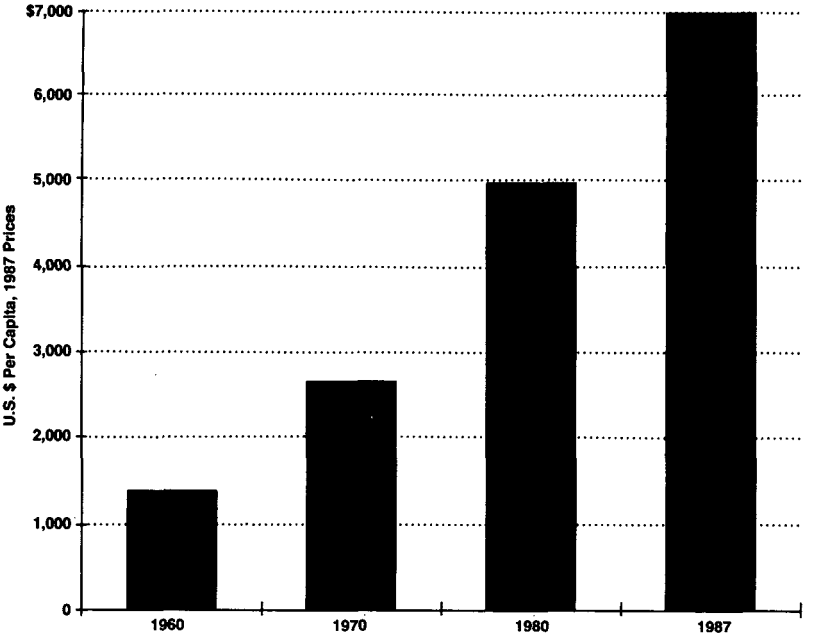
FIGURE 1

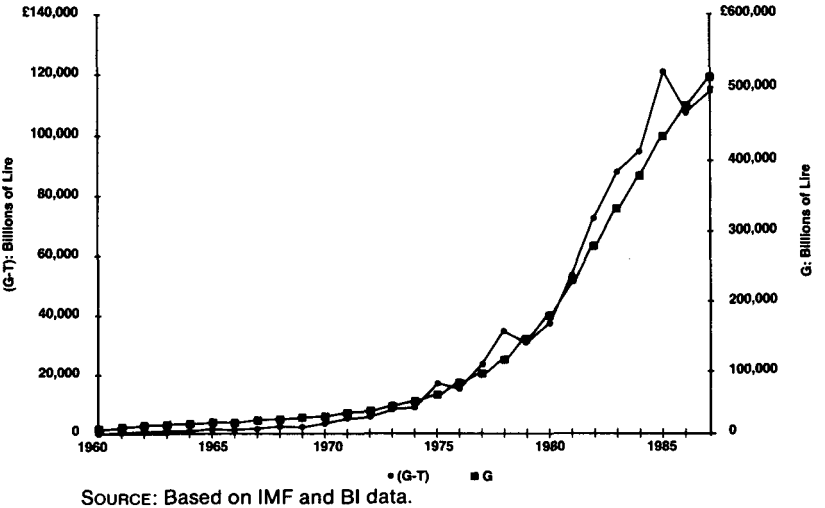
ITALY: REAL PER CAPITA COST OF GOVERNMENT, 1960–87



SOURCE: Based on IMF and BI data.

FIGURE 2

ITALY: BUDGET DEFICIT AND TOTAL SPENDING, 1960–87



SOURCE: Based on IMF and BI data.

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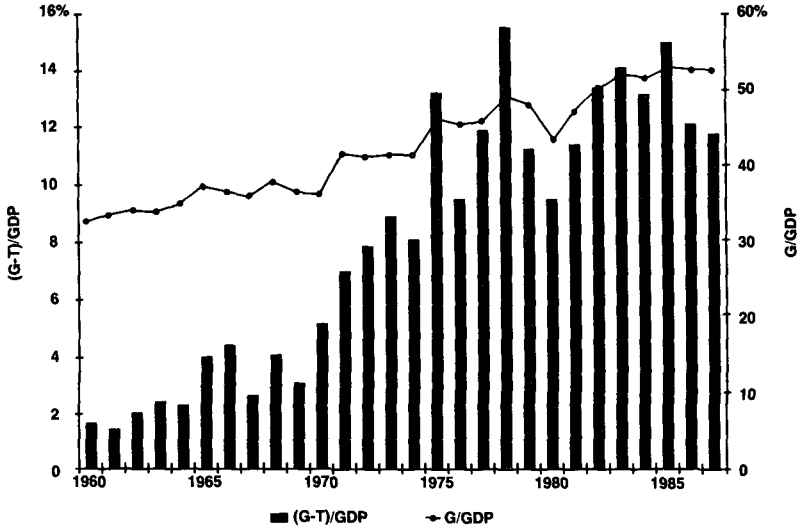
FIGURE 3

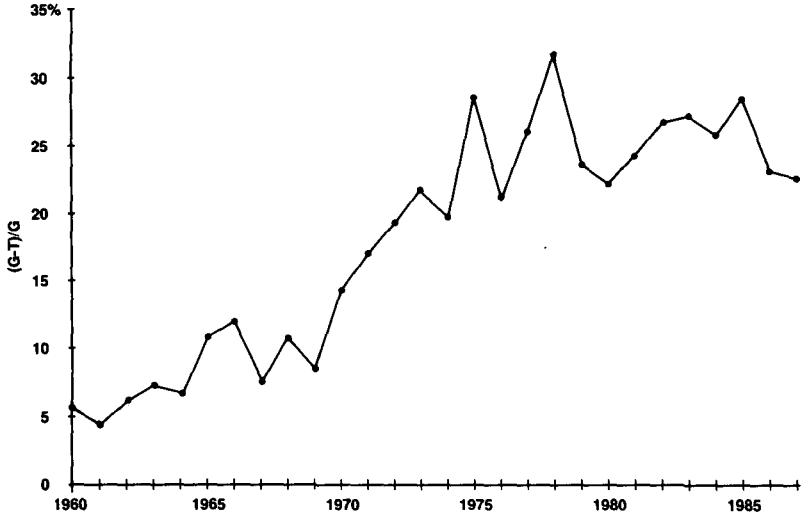
ITALY: GOVERNMENT DEFICIT AND SPENDING AS A PERCENTAGE OF GDP



SOURCE: Based on IMF and BI data.

FIGURE 4

ITALY: BUDGET DEFICIT AS A PERCENTAGE OF TOTAL SPENDING



SOURCE: Based on IMF and BI data.

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TABLE 7

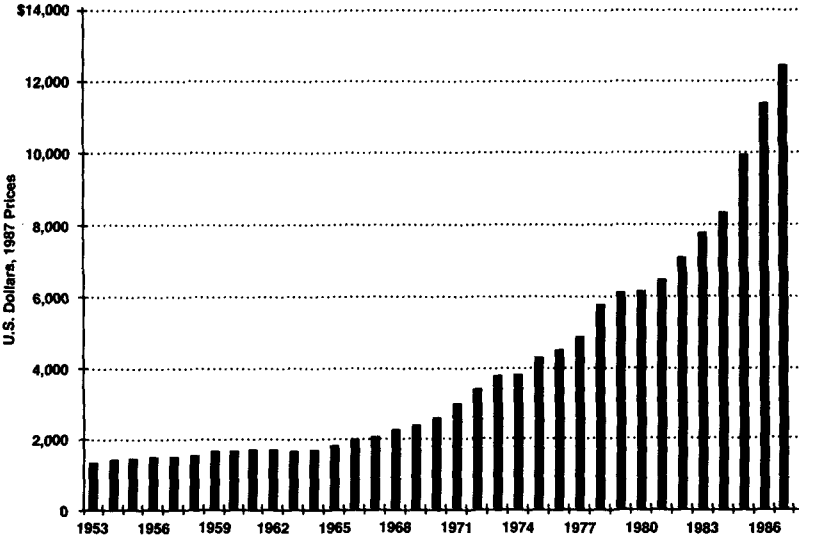
ITALY'S PUBLIC DEBT

	Billions of Lire			
	Current Prices	1987 Prices	Percent of GDP	Billions of U.S. Dollars 1987 Prices
1950	4,709	70,867	50.9	54.65
1955	7,300	91,765	48.6	70.76
1960	9,286	106,689	40.0	82.27
1965	13,378	121,139	34.2	93.41
1970	23,189	180,857	36.9	139.46
1975	67,087	305,682	53.5	235.72
1980	206,212	440,675	52.8	339.82
1985	654,261	724,433	81.2	558.63
1987	907,842	907,842	92.4	700.06

SOURCE: IMF, *International Financial Statistics, Yearbook 1987;* the 1987 figure is from Banca d'Italia, 1988.

FIGURE 5

ITALY: REAL PER CAPITA PUBLIC DEBT, 1987 PRICES



SOURCE: Based on IMB and BI data.

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in the deficit, the sharp reduction in the monetary growth rate in the past 8–9 years has been achieved despite the continued growth of the deficit. This fact seems to suggest that monetary policy can be effectively kept under control even in the face of large and growing deficits.

An Explanation

Gordon Tullock (1983) has maintained that we do not have a general theory of government growth, that all explanations of the rapid increase in taxation and spending in the postwar era are contradicted by the evidence: What is true for a given country at one time is not true for another country or for another period of time. In a sense, this is true by definition: The circumstances and the prevailing intellectual climate vary from country to country and over time. It is also true that a general theory should apply equally well to past trends as to contemporary developments. There is no doubt that we do not have any satisfactory explanation for such a wide range of events. But in another sense we do have a theory of government growth that explains fairly closely the prevailing tendencies in Western democracies during the last 25 to 30 years. It is not new, but it is worth mentioning.[1]

The starting point of such an explanation is the existence of three asymmetries in the perception of costs and benefits of public spending. First, the democratic political process tends to favor decisions that result in benefits for a small group of beneficiaries where the cost is spread over a large number of taxpayers (or consumers). For example, a decision to confer a benefit of, let us say, $230 million to 1,000 beneficiaries (say, a subsidy to the domestic exporters of a given good) gives each one of them a $230,000 incentive to make sure the proposal is approved. On the other hand, if the cost of the bill is spread evenly over the entire U.S. population, it would cost each and every American citizen only $1. "In these circumstances the outcome is not in doubt: the spoliators will win hands down" (Pareto 1896).[2]

The existence of such an asymmetry is confirmed by the realization that spending on public goods has not been the main factor behind the growth of total spending. Since public goods benefit the whole of society, they often lack a constituency lobbying for them, so that the growth of public spending is usually slower. There is further

[1]The following explanation draws on my 1986 paper.
[2]Quoted in Stigler and Friedland (1980).

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evidence of the existence of this asymmetry in the near-impossibility of reducing government spending, since the costs of the reduction would fall on a small number of former beneficiaries, and the benefits would go to society as a whole.[3] Finally, it is obvious that the success of the first group of beneficiaries will provide an incentive for the formation of other groups, so that the asymmetry results in a process of government growth that continues over time.

The second asymmetry occurs because the political process tends to favor decisions based on visible benefits and invisible costs. The visibility of benefits guarantees the support for the proposal by the potential beneficiaries, while the invisibility of costs neutralizes the opposition of the taxpayer-voters who will bear them. In the previous example, while each one of the producers of the good has an incentive of $230,000 to be exactly informed about the effects of the subsidy for him, the value of the information for the individual taxpayer is only $1. In all likelihood, therefore, while the beneficiaries will know exactly how much they stand to gain from the proposal, those who bear its cost will (rationally) be ignorant of its impact on them.

Finally, the political process favors decisions that result in an immediate (even if small) gain whose cost (even if large) is paid in the distant future. This last asymmetry is particularly acute in Italy because, given the high instability of the executive (the average "life expectancy at birth" of Italian governments is less than a year), the time horizon of political decisionmakers tends to be very short. Governments generally tend to favor spending decisions that confer an immediate gain to some group in society, even if the future cost of the decision is substantial, because in all likelihood it will be borne by another government.

If this analysis is correct, we would expect government growth to be faster when public spending is financed by a device that spreads costs over large numbers of taxpayers, hides these costs from those who bear them, and produces immediate benefits at the expense of high (if not disastrous) consequences in the future. Such a device exists, and it is called a deficit. Its time pattern—in Italy, at least—confirms the preceding analysis beyond any doubt.

I must stress at this point that the validity of this analysis does not depend on the existence of an *uninterrupted* growth of the deficit. What happens is that, when the deficit reaches a certain amount, the

[3]Compare Milton and Rose Friedman (1984, p. 42): "[There] is an asymmetry between the resistance to increasing the size of government and to decreasing it, between introducing new programs and dismantling them. An increase in the size of government is far less likely to run into concentrated and effective resistance—and, indeed, sabotage—than a decrease in the size of government."

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need to reduce it—stressed with great vigor by fiscal conservatives of all political parties—results in higher taxation. It is quite possible, therefore, that the asymmetries will produce increases in the deficit followed by increases in explicit taxation, and a reduction in the deficit, and so on. (This, however, has not been the case in Italy, where the deficit has grown with almost no interruption: See Table 5).

The "Friedman Effect"

Milton Friedman (1987, 1988) has argued that the existence of a budget deficit may prevent government from increasing spending: "Most commentators bemoan the large budget deficit. I welcome it. The deficit is the only thing that is forcing us to think seriously about how to control federal spending. The economic effect of the deficit is unquestionably bad, but the political effect of the deficit is good." And, more recently, "the deficit has been the only effective restraint on congressional spending."

Friedman was obviously referring to the situation in the United States in 1987. Given President Reagan's commitment not to increase taxation under any circumstance, the deficit is an effective deterrent to spending increases. However, if the U.S. president was not as concerned with excessive taxation as Mr. Reagan, the deficit, rather than restraining spending, would have provided a wonderful excuse for increasing taxation. Let's hope that the Bush administration will spare us conclusive evidence in favor of this assumption.

In other words, while I believe that the "Friedman effect" has been effective in the United States, I am convinced that it is not a lasting phenomenon. Sooner or later, perhaps after a change in government, the possibility of running a deficit will prove to be a force favoring the growth of spending rather than its containment.

This is so because, in the long run, the possibility of running a deficit allows the three asymmetries to operate unconstrained. In the words of James Buchanan (1983, pp. 17–18):

> Beneficiary groups, recipients of direct transfers or of governmentally financed programs, tend to be concentrated, organized, and capable of exerting influence over elected politicians. By contrast, taxpayer groups, those who pay taxes, tend to be widely dispersed and, indeed, tend to include almost everyone due to the fact that taxes are general rather than specific. As a result of the asymmetry, it becomes easier to get political decision makers to expand budgets than to contract them.

In other words, the asymmetries work unconstrained when budget deficits are possible, but they do not necessarily result in the unin-

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terrupted growth of the deficit, because governments alternate between fiscal prudence and folly. What the asymmetries guarantee is that the reduction of the deficit will always take place at a higher level of taxation and spending rather than at a lower level. But it is still the *possibility* of running a budget deficit that makes it possible for spending to keep growing uninterruptedly.

Italy, the Constitution, and Keynes

An objection arises at this point. The structure of incentives affecting the behavior of voters, politicians, and taxpayers so as to promote the growth of government can be assumed to have existed ever since mass democracy was born. Why, then, did government deficits not start to increase in Italy until the early 1960s?

The extraordinary paradox of the Italian case is that Italy has a fiscal Constitution that was intended precisely to avoid the kind of financial disorder we now experience, by forcing spending decisions to conform to a standard of financial responsibility. Unfortunately, the constitutional constraint did not succeed.

The cornerstone of Italy's fiscal Constitution is the last paragraph of Article 81, which reads: "Every other law which involves new or greater expenditures must indicate the means to meet them." The intent of the authors of this article is made explicit in the published proceedings of the discussion that preceded its approval. Their aim was that of ensuring a responsible approach to spending decisions and a tendency toward a balanced budget. Since the previous paragraph of Article 81 forbids the introduction of new taxes and expenses in the budget law, the combination of the two principles should have resulted in a "rigorous constraint" on the formation of increases in the deficit. The meaning of the rule embodied in the last paragraph of Article 81 is unequivocal to anyone who reads the proceedings of the Constitutional subcommittee; its implications are even clearer to economists familiar with the work of Knut Wicksell, who, as early as 1896, had recognized the need to couple spending proposals with specific plans for covering their costs as a way to achieve financial responsibility.

The constitutional constraint worked rather well until 1961. As shown in Table 5, from 1951 to 1961 the government deficit in Italy declined 8 percent in nominal terms or 24.5 percent in real terms, and as a percentage of GDP, it went from 3.74 in 1951 to 1.38 in 1961—a 63 percent decrease. The budget was not balanced, but the *tendency* was there: As a percentage of GDP, the deficit was cut substantially in the 1950s. Then the trend changed: From 1961 until

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today, the growth of the deficit is one of the few certainties of economic life. Why?

In my opinion, the answer is threefold. First, there is the impact of the "Keynesian revolution." As long as the "balanced-budget norm" prevailed, the formation of larger budget deficits was discouraged, and the constitutional constraint was enforced. Until 1961, there have been 12 cases of laws sent back to Parliament by the president of the Republic, who refused to sign them because they violated Article 81 of the Constitution. After the political change of the early 1960s—the "opening to the left" (the formation of a government coalition including the Socialists)—and the advent of the "Keynesian revolution," the "balanced-budget norm" was replaced by the Keynesian mythology of deficit spending. The various presidents of the Republic did not avail themselves of their veto power, and the Constitutional principle was no longer enforced. The working of the three asymmetries became unconstrained, and the budget deficit exploded.

The rapid growth of government can therefore be attributed to the combined effect of the system of political incentives typical of the democratic political process on the one hand, and the consequences of the "Keynesian revolution" on the other. The "decoupling" of decisions on spending and taxing, made possible by the abandonment of the "balanced-budget norm," has allowed taxation and spending to grow rapidly in response to the political pressures resulting from the three asymmetries mentioned above.

The evidence, in Italy at least, confirms the validity of Buchanan and Wagner's conclusion (1978, p. 27):

> The mounting historical evidence of the ill effects of Keynes's ideas cannot continue to be ignored. Keynesian economics has turned the politicians loose; it has destroyed the effective constraint on politicians' ordinary appetites to spend and spend without the apparent necessity to tax.
>
> Sober assessment suggests that, politically, Keynesianism represents a substantial disease that over the long run can prove fatal for the survival of democracy.

In addition to the deleterious consequences of Keynesianism, two more factors contributed to the abandonment of the constitutional rule. First is the general nature of the Italian Constitution: an ambiguous, quixotic, and often unenforceable document. Second, the last paragraph of Article 81 could have been (and should have been) expressed in a more specific way, so that it could be either enforced or *openly* violated. As it happens, it has been possible to by-pass it by "interpreting" it in a more flexible manner. For example, when a

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bill introduces an expenditure destined to continue in the future, politicians and "constitutional experts" maintain that the principle is respected if the law "indicates the means" to finance the expense for the first year, even if it ignores the necessity to raise the funds for the following years.

Conclusions

These last two factors could and should have been avoided: There is no reason why the Italian Constitution should make delightful reading for anyone opposed to written constitutions. Also, the constitutional principle could have been phrased in a more explicit and binding way. It is impossible to tell a priori, however, if a better worded rule within the framework of a meaningful constitution would have stood the test of the change in intellectual climate brought about by Keynesianism. But, on the other hand, we should probably avoid the extreme pessimism of Anthony de Jasay, who, in his admirable book (de Jasay 1985), likens constitutional rules to chastity belts: "With its key always within reach, a chastity belt will at best occasion delay before nature takes its course" (p. 187).

Even if the introduction of a constitutional rule is only a temporary remedy, in that, sooner or later, politicians will try to bypass it, it is the only chance a democracy has to contain the displacement of individual liberty by the growing Leviathan. It is not accidental that, in the Western world, countries with a federal constitution or a constitutional rule (such as Switzerland, Finland, or the United States) are those that have the best record in the containment of government growth.

The Italian experience should teach other countries that a fiscal constitution is necessary. Indeed, if one agrees that the "Italian disease" is only a more acute form of the same illness that affects all Western societies, the need for a set of constraints on irresponsible spending decisions is an urgent one. It is the most a country can do to avoid falling into the kind of financial disarray that is currently plaguing Italy.

But the Italian experience also teaches another, less optimistic, lesson: Although monetary and fiscal constitutions are necessary, they are far from being a sufficient guarantee against excessive and irresponsible government. There is no such a thing as a foolproof legal device that can protect us forever. There is no substitute for our constant alertness, for our awareness of the threat posed to our freedom by an increasingly intrusive Leviathan.

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Sanctioning South Africa: The Politics behind the Policies

William H. Kaempfer and Anton D. Lowenberg

Introduction

The existing literature on international economic sanctions emphasizes the ineffectiveness of economic measures, such as trade embargoes and investment boycotts, in bringing about their intended foreign policy objectives. Economists, for example, have shown that world markets provide considerable possibilities for substitution of alternative sources of supply and alternative markets, so that trade restrictions are relatively easy to circumvent (Bayard, Pelzman, and Perez-Lopez 1983; Hufbauer and Schott 1985; Black and Cooper 1987). Even supposing that sanctions are successful in inducing economic damage in the target nation, political studies have demonstrated that the political consequences are quite often the opposite to those intended. For instance, the residents of the target country will sometimes "rally around the flag" and lend increased political support to the ruling regime (Knorr 1975, p. 154; Doxey 1980, pp. 120–21; Renwick 1981, p. 87; Lowenberg 1987, p. 29).

Recent years have seen a proliferation of sanctions episodes—for example, those directed by the United States against Iran, Libya, Nicaragua, Panama, Japan, and Brazil, as well as South Africa. However, if the link from economic sanctions to economic dislocation in the target country is weak and if the link from economic dislocation to a desired political response is even weaker, then the question of why economic sanctions continue to be used at all remains evasive.

The purpose of this paper is to apply a public choice approach to explain the use of economic sanctions as an instrument of foreign

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policy, and then to examine the predictions yielded by public choice theory in the light of recent sanctions episodes. We treat sanctions as endogenous regulations that restrict trade or factor movements between nations. Like any other regulatory intervention, sanctions are income reducing in aggregate, although they create redistributions of income favoring some groups at the expense of others within the domestic economies of both the target country and the sanctioning country. The advantage of this method is that it is able to account for the adoption of sanctions strategies in the sanctioning nations that have minimal economic impact on the target country.

The traditional view of economic sanctions is an instrumental one—namely, that the purpose of sanctions is to inflict the maximum amount of economic harm on the target country in order to induce a change in some objectionable policy pursued by that country's government (Kaempfer and Lowenberg 1988b; Lundborg 1987, p. 5). According to this approach, which we label the "damage hypothesis," an economic sanctions package that does the most damage (per unit of cost to the sanctioner) will generate the greatest chance of a favorable policy change in the target country. The sanctioner determines the magnitude of the costs it is willing to incur by assessing the amount of damage it wishes to impose on the target.

We propose an alternative view, however, based on a public choice analysis of endogenous policy, which we call the "self-interest hypothesis." According to this approach, interest group competition within the sanctioning country determines the extent and type of sanctions selected. Interest groups vary in terms of their lobbying efficiencies and capacities for rent seeking. Producer groups, for example, are small and cohesive, and can easily control free riding among their members, whereas large consumer groups tend to be less effective in exerting political influence. Politicians respond to the pressures of competitive interests by supplying regulation up to the point where the summed marginal utilities of the beneficiaries equal the summed marginal disutilities of the losers (Peltzman 1976). If the regulation in question creates a net deadweight loss (the losers lose more than the beneficiaries gain), and if all interest groups are identical in terms of their abilities to produce political pressure, then the regulation will not be enacted. However, if the beneficiary groups are more effective in exerting influence than the loser groups, then a positive quantity of the regulation might be "politically efficient," despite the fact that it is wealth reducing for society as a whole (Becker 1985; Kaempfer and Lowenberg 1988b).

If we treat the sanctions package implemented by a sanctioning nation as an endogenous regulatory outcome, then the structure and

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composition of the sanctions are determined by the interplay of competitive interest group pressures within that nation's domestic polity. Interests in economic sanctions vary between groups. One group, comprising individuals with so-called noble interests, gains direct utility from a desired policy change in the target country (this is a form of altruism). A second group, which we shall identify as having a "symbolic" interest in sanctions, gains utility from the adoption of a particular policy stance, regardless of the actual impact of that policy on the target country. Bagnoli and Lipman (1987) have characterized this source of utility as "warm glow" altruism. A third group possesses a "base" interest in sanctions to the extent that it receives a net transfer of wealth that is a by-product of the sanctions.

The enactment of economic sanctions, however, entails some real costs and thus some real political opposition. Consequently, those with noble interests favoring sanctions will usually need to form logrolling coalitions with those possessing symbolic and base interests in order to overcome political opposition. In the absence of such coalitions, since sanctions cause allocative distortions and reduce total income, the opposition of groups that lose income due to the sanctions would likely be sufficient to prevent the sanctions from being implemented (Kaempfer and Lowenberg 1988b).

This paper focuses attention on the process of policy formation within the sanctioning country. In order to test the validity of the self-interest hypothesis, we examine the structure of sanctions against South Africa adopted by the United States, the European Economic Community, and Japan. The self-interest approach leads us to expect that the type of sanctions policy implemented by a nation will reflect competitive interest group pressures in the political system. In many instances, the real purpose of pro-sanctions interest groups in the sanctioning country is to send a signal of disapproval of the target country's policies, or to establish an international reputation, or to restrict imports in order to benefit a domestic industry. Furthermore, interruptions of trade and investment are costly to the sanctioner as well as to the target country. Therefore, it follows that the types of sanctions selected by the sanctioner will be such as to communicate the strongest possible signal for any given economic cost. Goods selected for embargo are likely to be traded in markets where either substitution possibilities are considerable, so that the market impact of the boycott is minimized, or a rent-seeking domestic interest group is likely to benefit from the sanction. This view conflicts with the standard view of sanctions, according to which they are designed specifically to impose maximum market dislocation in the target country.

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Testable Implications and Data

Total embargoes of trade and other economic relations with a target country are rarely implemented by sanctioning countries. Generally, embargoes are selective, that is, they target particular goods or particular factors of production. The political process within the sanctioning country determines which specific trade or investment links between countries will become the targets of sanctions. A careful examination of this political process, and the resulting sanctions, enables us to test both the damage hypothesis and the self-interest hypothesis. Specifically, it is possible to examine whether the actual goods selected for sanctioning are chosen because those boycotts will maximize economic harm in the target country, or because they are the politically efficient outcomes given the configuration of interest groups in the sanctioning country.

We set forth four separate implications of the self-interest hypothesis. First, this hypothesis suggests that the sanctioner's imports, and especially imports of final goods, will be restricted more frequently than the sanctioner's exports. Protectionist or neomercantilist self-interest seeks to ensure that domestic producers of import substitutes benefit from trade restrictions at the expense of consumers of those goods. On the other hand, export firms lose when cut out of foreign markets, while domestic consumers of those exportables gain from lower domestic prices. However, producer groups tend to have more political influence than consumers due to their ability to overcome free-riding difficulties (Destler 1986). Consequently if export goods are observed to be the chief target of sanctions, it is likely that base self-interests play an unimportant role in determining the nature of those sanctions. However, if sanctions fall largely on imports, the self-interest of import competing industries is likely to have been important in shaping the sanctions strategy.

Second, if the sanctions implemented do not generate significant income transfers favoring some major interest groups at the expense of others, then it is unlikely that those sanctions are motivated primarily by base self-interests. It is more likely that pressure for such sanctions derives from nonpecuniary motives ("noble" or "symbolic" interests), or that the pressure for sanctions arises according to the damage hypothesis.

Third, we ask whether the boycotted goods are in fact traded on a significant scale between the sanctioner and the target country. If maximum economic harm is the intent of a sanctions package, then the sanctions must fall on significantly traded goods.

Fourth, the economic impact of trade restrictions depends on the elasticities of world excess demand and supply curves facing the

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target. Thus, if world demand and supply are very elastic, the target falls into the "small country" category and is very likely to be able to find substitute markets in which to trade. If the target is a "large country" facing imperfectly elastic supply and demand curves in markets for its sanctioned goods, then the sanctions will have a price impact so long as the sanctioning country is a signficant trade partner of the target.

These last two implications will be tested by examining the relevant market shares. Thus, for a given world elasticity of import demand, the smaller the share of the target country's exports going to the sanctioner, the more elastic the world import demand curve net of the sanctioner's demand. Likewise, the smaller the share of the target country's imports originating in the sanctioning country, the greater the remaining elasticity of supply of exports from the rest of the world. However, even when the volume of trade between the target and the sanctioner is large, if the world market provides a significant array of substitution possibilities for a particular good—that is, if the target's share of total world trade is small—then little economic harm will result from a boycott of that good.

During 1986 most of the major Western nations implemented sanctions against South Africa (*Congressional Quarterly*, 27 September 1986). While there are remarkable similarities between the sanctions packages, there are also some important differences. We examine the sanctions imposed by the United States, Canada (as a representative of the Commonwealth), the United Kingdom, West Germany (as a representative of the European Economic Community), and Japan. Five different anti-apartheid sanctions packages were endorsed, implemented, or extended in August and September 1986 by these nations or groups of nations. The sanctions fell into five broad categories: disinvestment, bank loans, import restrictions, export restrictions, and landing rights (or tourism) restrictions. We focus on the import and export restrictions, which are detailed in Table 1.

The pattern of trade for South Africa in 1985 is summarized in Table 2. Data for three basic import categories (iron and steel, textiles, and coal) are presented. Textile trade is divided into three components: fibers, fabrics, and apparel. Table 2 presents the total 1985 dollar amount of imports from South Africa into the sanctioning countries, as well as the share of those countries' imports with respect to the total exports of South Africa to all OECD nations. The share of South African exports in total OECD imports from all countries is also given. These data do not include explicitly South African trade with non-OECD nations, notably other Southern Cone nations in South America, Israel, and some of the newly industrialized nations

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TABLE 1

MAJOR TRADE SANCTIONS IMPOSED AGAINST SOUTH AFRICA IN 1986

Country	Imports	Exports
United States	Steel and Iron Coal Textiles Agricultural Goods Uranium Krugerrands	Oil Computers to Apartheid Enforcing Agencies
United Kingdom	Steel and Iron Krugerrands	Oil "Sensitive" Equipment to Police and Army
European Economic Community	Steel and Iron	Oil "Sensitive" Equipment to Police and Army
Canada and Other Commonwealth Countries	Steel and Iron Coal Agricultural Goods Uranium Krugerrands	
Japan	Steel and Iron Krugerrands	Computers to Apartheid Enforcing Agencies

SOURCE: *Congressional Quarterly*, 27 September 1986, p. 2271.

of the Far East, which are all significant trading partners for South Africa. However, Table 2 does provide information on South Africa's share of total world trade in each category.

Evidence from the 1986 Anti-Apartheid Sanctions

Table 1 lists the various sanctions imposed against South Africa by important sanctioning countries and groups of sanctioning countries during 1986. Of the nine product categories restricted by one or more countries, seven are imports: steel, iron, coal, uranium, textiles, Krugerrand coins, and agricultural products. This list seems to support the view that the structure of a sanctions package is strongly influenced by pressure on the part of interest groups whose motives are not primarily to punish the target country. In other words, neomercantilist interests, striving to diminish imports in general, will regard

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TABLE 2

FLOWS OF SANCTIONED SOUTH AFRICAN EXPORTS

Sanctioning Country	Product	Share of Total South African Exports to OECD (%)
	Iron and Steel	
United States	293,621	31.2
United Kingdom	43,257	4.6
West Germany	111,533	11.9
European Economic Community	274,518	29.2
Canada	20,153	2.1
Japan	192,571	20.5
Total S.A. Exports to OECD	940,982	83.0
		S.A. Share of OECD Imports
Total OECD Imports	39,223,837	2.4
		S.A. Share of World Trade
		1.6
	Textile Fibers	
United States	11,398	3.9
Total S.A. Exports to OECD	294,941	S.A. Share of OECD Imports
		3.0
Total OECD Imports	9,869,847	S.A. Share of World Trade
		1.7
	Yarn and Fabrics	
United States	22,256	15.9
Total S.A. Exports to OECD	140,026	S.A. Share of OECD Imports
		0.4
Total OECD Imports	34,618,015	S.A. Share of World Trade
		0.4
	Apparel	
United States	40,693	64.8
Total S.A. Exports to OECD	62,786	S.A. Share of OECD Imports
		0.1
Total OECD Imports	42,151,892	S.A. Share of World Trade
		0.1
	Coal	
United States	43,418	3.3
Canada	0	0.0
Total S.A. Exports to OECD	1,317,881	S.A. Share of OECD Imports
		9.3
Total OECD Imports	14,179,898	S.A. Share of World Trade
		7.1

NOTE: All data are in thousands of 1985 dollars, except South Africa's shares of world trade that were calculated using 1982 data.
SOURCES: OECD, *Import Export Tables;* and the United Nations Trade Data System, 1987.

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the elimination of imports from a particular country as a partial step toward the attainment of their ultimate protectionist goal.

The two sanctioned export categories, oil and computers (or other sensitive equipment for apartheid enforcing agencies), both merit special attention. In general, oil exports are very insignificant, or zero, from the United States and most European Economic Community countries. Furthermore, the restriction of oil exports to South Africa is, for most countries, an extension of an earlier sanction on exports of domestically produced oil, but it does not affect transshipment of oil. Since the downfall of the Shah of Iran in 1979, only Brunei has admitted to exporting oil to South Africa (Kaempfer and Lowenberg 1988a). (It should be noted that South Africa has no oil reserves, although a domestic synthetic-oil-producing industry has been developed to reduce import dependence.) In addition, South Africa has been able to purchase oil on the spot market. A ban on exports of domestically produced oil to South Africa is therefore not likely to cause severe economic damage in that country.

The ban on computers and other sensitive equipment like weapons for apartheid enforcing agencies and the army must be treated separately from traditional economic sanctions on exports. This treatment is because these sanctions are not usually justified on the grounds that they will change apartheid by inflicting economic harm on South Africa. Rather, the intent of these instruments is to directly raise the costs of enforcing apartheid policies. As such, they have strong symbolic value to interest groups within the sanctioning countries that desire to adopt a visible anti-apartheid stance or send a signal of disapproval to the South African regime. This appearance is certainly consistent with the self-interest hypothesis.

The second implication associated with the self-interest hypothesis suggests that imports selected for embargo are likely to be those that attract strong protectionist pressure on the part of import-competing industries. Clearly this is an easily justifiable contention for the steel, iron, and textile industries. These sectors are among the most protectionist in OECD nations, and they are quite as likely to welcome country-specific protection as across-the-board measures. This attitude is particularly notable in the case of textiles, since South Africa is not a party to the Multifiber Agreement and its exports therefore escaped one level of trade restrictions prior to sanctions.

A similar case can be made for some embargoed agricultural products. Only the United States restricted trade in agricultural commodities. European nations, which are heavy consumers of produce from South Africa in the winter, chose not to embargo this category of goods. While the United States does import some out-of-season fruits

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and vegetables, it also imports sugar, which is the subject of strong protectionist pressure. It is interesting to note, however, that the South African sugar quota was not eliminated to raise the overall level of protection in the United States. Rather, it was transferred to the Philippines. This fact suggests the possibility of an implicit logrolling alliance between the anti-apartheid lobby and the pro-Aquino lobby, which was strong enough to overwhelm the interest of sugar producers in eliminating South Africa's quota altogether.

It is likely that the governments of the sanctioning countries are themselves a powerful interest group seeking a restriction in trade in Krugerrands. Most governments have entered the business of issuing gold coins for general consumption. South African Krugerrands, however, have always been a source of competition in this business as they were an early entrant into the market. Since gold bullion was not embargoed by any government, one can presume that South African gold is still being coined for sale to the general public. However, it is being coined in the consuming countries rather than in South Africa.

The two energy import categories, coal and uranium, seem to refute the self-interest hypothesis. They are intermediate goods whose protection would be theoretically opposed not only by consumer interests, but also by final goods producers, especially the power generating industry. Moreover, they are not goods that generally attract heavy protection. Nevertheless, we might conjecture that there exists a coalition between the pro-sanctions lobby and some other interest group for each good. Anti-nuclear interest groups have a strong desire to keep the nuclear power industry heavily regulated; thus they might seek this extra sanction on one foreign source of uranium to further their aims. In the case of coal, only the United States and Canada (or the Commonwealth) applied an import embargo. Significantly, these countries are not large overall importers of coal and in fact are major exporters in competition with South Africa. The intent of the American and Canadian sanctions on coal may have been to pressure Europe, which is a heavy importer of South African coal, to levy a similar import ban. Such a move would have secured almost the entire European market for North American exporters.

Sanctions in the area of landing rights and tourism can also be subjected to the interest-group test. The United Kingdom called for a voluntary end to the promotion of South African tourism and tourism promotion was banned by the Commonwealth sanctions package. Since 46 percent of all tourists in South Africa in 1984 were from Commonwealth nations, this ban seems to be a significant step. However, some Commonwealth countries (notably Kenya, Zimbabwe,

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and Zambia) are probably important competitors with South Africa for the tourist trade. Thus, this specific sanction might have had as much to do with a desire to divert tourists elsewhere as a desire to cause economic harm to South Africa.

The United States ended landing rights for South African Airways while Japan and the Commonwealth imposed a ban on all air links with South Africa. The Commonwealth sanction in particular would prove to be a significant action against South Africa if it were enforced, since many flights to South Africa are routed through Kenya or Zimbabwe. (However, a few African countries such as Cape Verde Island and Mauritius remain available as substitutes.) But although Zimbabwe was an important party to the Commonwealth sanctions agreement, it has yet to restrict landing rights in its own territory or impose any other sanction (Anglin 1987). This fact suggests that the call for sanctions itself might be more important to the countries involved than the actual imposition of costly sanctions.

Even if special interests are partially behind the sanctions applied against South Africa, those sanctions could nevertheless induce significant harm. Traditional analysis of economic sanctions suggests that embargoes are most damaging when they are implemented in markets where demand and supply are inelastic (Hufbauer and Schott 1985, Black and Cooper 1987). The last two implications of the self-interest hypothesis, as stated in the previous section, are concerned with this elasticity issue and the consequent ability of economic sanctions to cause economic damage.

In assessing the potential for damage, it is necessary to determine whether the sanctioner imports a significant portion of the boycotted good from South Africa. Consider a given market for some South African export with a given elasticity of world excess demand. When one country removes itself from the market by boycotting South Africa's export, the elasticity of excess demand of the remaining buyers must fall. The greater the share of the South African export going to the sanctioning country, the greater will be the reduction in the elasticity of the residual demand. If this residual demand elasticity is reduced to a small magnitude as a consequence of the withdrawal of the sanctioner from the market, then the remaining buyers' demand price for the South African export is likely to fall considerably. Such a fall in price and export earnings can inflict severe damage on the South African economy. If, however, the sanctioning nations' share of South Africa's exports is small, there will be little change in the elasticity of the residual demand.

The evidence in Table 2 is mixed on this issue. Three different categories of textile trade are examined: fibers, fabrics, and apparel.

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Only the United States levied a sanction against textile imports. The U.S. share of total South African exports to the OECD is 3.9 percent for fibers, 15.9 percent for fabrics, and 64.8 percent for apparel. However, there is an inverse relationship between the size of the U.S. share (and the dollar value of imports) on the one hand, and the importance of the export to South Africa. Specifically, South Africa exported almost $300 million of fibers to OECD countries, but less than $150 million of fabrics and only $63 million of apparel. Losing 65 percent of its apparel export market may cause South Africa some economic harm, but the relatively low level of apparel exports mitigates the extent of the harm.

The evidence on coal trade, however, casts serious doubt on the damage hypothesis. Only the United States and Canada implemented coal import sanctions. Prior to the imposition of these sanctions, United States imports of South African coal amounted to $43 million, which was 3.3 percent of South Africa's total coal exports to the OECD. Canada actually embargoed imports of a good it did not import in the first place. Thus South Africa was left with most of its initial coal market intact following the sanctions and would presumably not find it too difficult to replace the $43 million of lost coal sales. Any economic damage caused by the sanctions would be minimal.

Finally, imports of iron and steel from South Africa were embargoed by all of the trading partners listed in Table 2. The United States, Japan, Canada, and the European Economic Community imported 83 percent of South African iron and steel exports to the OECD in 1985, which is not surprising considering that these countries account for the bulk of economic activity in the OECD. The elimination of this trade could be potentially damaging to the South African economy, since it might induce either a cut in export prices so as to increase sales to nonboycotting countries, or, failing that, a reduction in output.

However, the analysis above assumes a given world elasticity of demand for South African exports. When the sanctioning country's market is removed from the world market, the residual demand of the rest of the world for South African exports becomes less elastic. The resulting degree of inelasticity of demand in South Africa's remaining export markets, however, depends not only on the share lost due to sanctions, but also on the initial elasticity of world import demand. Thus, for maximum economic damage to the target country, sanctions should be imposed in markets where the world demand is inelastic to begin with. For example, if South Africa were a "small country" in the sense that it faced a perfectly elastic world excess

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demand curve, then sanctions by one country, or even several countries, would have no impact on South African exports.

In order to approximate the elasticity of world demand for each category of South African exports affected by sanctions, we examine the share of each export in total OECD trade and total world trade. In the case of iron and steel, which is boycotted by all the major OECD countries, the South African share of total OECD imports from all sources is only 2.4 percent. Even this small share overstates the significance of South African exports on the world market, where South Africa's iron and steel exports compose only a 1.6 percent share. Therefore, even if excluded from most of the OECD market, South Africa might well be able to find alternative buyers for its iron and steel in non-OECD (and nonsanctioning) countries such as Argentina, Chile, Israel, and some of the Asian newly industrialized countries. In effect, South Africa's small share of world trade in iron and steel enables substitutions among buyers of its iron and steel exports and, consequently, mitigates to a large extent any potential for economic harm in this category.

The damage to South Africa induced by the U.S. ban on textile imports is even more doubtful. The South African share of total OECD imports is only 3 percent, and its share of world trade is 1.7 percent for fibers. The corresponding figures for fabrics and apparel are 0.4 percent and 0.1 percent respectively (OECD imports account for the bulk of world trade in these goods). Thus, even though the United States imports 65 percent of South African apparel exports, the small share of total South African apparel exports in world trade implies that the residual demand curve is highly elastic. Therefore South Africa should be able to find alternative buyers for all of its textile exports, without a major fall in export prices or quantities.

The coal embargoes lend strong support to the self-interest hypothesis even though South Africa commands a fairly large share (7.1 percent) of the world coal trade. Prior to sanctions, 9.3 percent of OECD coal imports originated in South Africa. Furthermore, these imports composed 14.9 percent of South Africa's total exports of all goods to OECD countries of $8.8 billion. If all OECD members were to embargo coal imports from South Africa, the costs to South Africa would be significant. However, only the United States and Canada imposed such a sanction and the share of trade involved was only 3.3 percent of South Africa's coal exports. Europe and Japan, on the other hand, are major importers of South African coal (their markets accounting for $1.2 billion of the $1.3 billion of South Africa's coal exports to the OECD), and they chose not to sanction coal. Presumably, the costs of a coal sanction to those interest groups within

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Europe and Japan that would lose from such an embargo if it were sufficiently high to induce a strong lobbying effort against anti-apartheid and other pro-sanctions interests. Undoubtedly, the United States applied pressure on the European Economic Community and Japan to implement a coal embargo, which would benefit United States coal exporters (*Los Angeles Times*, 3 April 1988, Pt. v, p. 2).

Finally, there does not appear to be much potential for sanctions on other categories of traded goods to create severe economic damage to South Africa. An almost total embargo of oil exports to South Africa has been in place since 1979. This embargo has caused South Africa to resort to expensive alternatives to oil like coal liquification, but oil imports continue through world spot markets. Krugerrand import bans do not interfere with the export of gold bullion from South Africa, and may cause a substitution into bullion imports as Krugerrands are replaced with gold coins minted in the sanctioning countries but probably out of South African gold. Sanctions on South African agricultural exports are much like coal sanctions. South Africa is a major exporter of many different agricultural commodities. However, the nations that did implement such restrictions, the United States and Canada, are not major importers from South Africa. In general, there is not much evidence to support the hypothesis that the sanctions which were applied against South Africa were chosen in order to create a great deal of economic damage in South Africa.

Conclusion

A public choice approach to economic sanctions suggests that the type of sanctions selected by the sanctioning countries will reflect competitive interest-group pressures in those countries and will not necessarily be designed so as to maximize economic damage in the target country. This paper has examined empirical evidence on actual sanctions episodes (OECD sanctions against South Africa) in order to determine whether sanctions are geared mainly to maximize economic damage or whether they are shaped largely by special interests without regard to their impact on the target.

In general, it appears that the 1986 sanctions levied against South Africa provide more support for the self-interest hypothesis than the damage hypothesis. The special interest view, for example, implies that sanctioners will boycott the exports of the target country rather than restrict their own exports to the target. This view holds true for the case of South Africa, thus lending support to the self-interest hypothesis. In addition, the imports from South Africa selected for embargo are often those that compete directly with domestically

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produced goods in the sanctioning countries and therefore attract neomercantilist protectionist pressure. Again, this fact fits the special interest perspective on sanctions.

The impact of trade restrictions on the target country depends on the elasticity of world excess demand and supply curves and on the share of the target's imports or exports accounted for by the sanctioners. For example, even if the sanctioners import a large share of a particular export good of the target country, and then subsequently close their markets to the target, the impact on the latter country will be minimal if remaining world demand for that export is highly elastic.

In the case of the 1986 South African sanctions, the sanctioning countries usually chose to boycott those imports that composed a small share of South Africa's total exports of the good in question, for example, American and Canadian coal and agricultural sanctions. Even when the sanctioning countries accounted for a large share of South Africa's exports, the total volume of trade between them and South Africa was generally small relative to world trade, suggesting a highly elastic demand by the rest of the world and readily available substitute markets (this is the case of OECD iron and steel sanctions). Alternatively, in some instances, a sanctioner imports a large share of South Africa's total exports of a particular good, but the importance of those exports to South Africa (in terms of their share in total South African exports of all goods) is small, for example, U.S. sanctions on South African apparel. In both of the latter cases, the level of economic damage to the South African economy is minimal.

Thus, the composition and coverage of economic sanctions strategies appear to reflect the exigencies of interest-group politics within the sanctioning countries. At least in the case of the recent sanctions episodes against South Africa, this motive for sanctions outweighs a purely instrumental intent to inflict economic harm.

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Antitrust and Insurance: Should the McCarran Act Be Repealed?

D. T. Armentano

The McCarran-Ferguson Act (PL-15) passed in 1945 exempts the state-regulated property-casualty (P/C) insurance industry from important sections of the federal antitrust laws. There are a number of proposals currently in Congress, supported by a few industry representatives and many industry critics, that would repeal the McCarran-Ferguson Act (MFA). The focus of this study will be to examine whether the repeal of the P/C insurance industry's antitrust exemption would be intelligent public policy.

A Brief Regulatory History of P/C Insurance

Property/casualty (or liability) companies insure individuals, business organizations, and governments against the risks associated with personal injuries or the loss of property. In 1986 there were approximately 3,600 P/C insurance companies in the United States with net premium income of $176 billion and total industry assets of $374 billion (*Standard and Poor's*, January 1988; *Best's Review* January 1988).

The industry's antitrust exemption can be understood only in a broad historical context. The 19th-century fire insurance industry was a curious mix of business rivalry and interfirm cooperation. There was intense rivalry among insurers for the business of independent agents who actually sold or "placed" insurance. There was also vigorous competition among the independent agents themselves to sell insurance products. Since insurers could not control the agents directly,

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there was always the danger that severe price competition would threaten insurer solvency. Aside from the intense rivalry, however, there was also substantial interinsurer cooperation. There were industrywide agreements among insurers to pool loss experience data so that rational insurance prices might be determined. In addition, insurance companies often formed boards or compacts (cartels) in an attempt to control both the rivalry for agents and their unpredictable pricing behavior.

During the 19th century, state regulation of the insurance business was minimal (the setting of modest capital and surplus requirements), although some states did pass "anticompact" laws (1885–1907) in an attempt to restrict insurer rate collusion. There was an absence of federal regulation or antitrust intervention in the industry since the Supreme Court decision in *Paul v. Virginia*[1] had determined that selling insurance was not "commerce."

Intercompany agreements among insurers to stabilize prices were notoriously unsuccessful. Participating companies and agents would break the voluntary cartel agreement whenever it was in their individual interest to do so. Indeed, the alleged problems of inadequate rates and potential insurer insolvency were equally as important a public policy concern as price collusion, and led the Merritt Committee in New York (in 1911) to recommend that New York State regulate insurance company ratemaking (Day 1970). Other states followed New York's lead, and a system of state regulation of insurance rates came to exist in most states for many different types of P/C insurance by 1944.

In *U.S. v. South-Eastern Underwriters Association*,[2] the Supreme Court unexpectedly held that insurance activity that crossed state lines did constitute "commerce" and was fully subject, therefore, to the federal antitrust laws. The imminent application of the federal antitrust laws to insurance threatened the entire system of joint ratemaking and many other cooperative activities, and sent tremors throughout the industry. The major insurers, the agent organizations, and the state regulators mobilized quickly (led by the influential National Association of Insurance Commissioners), and Congress quickly passed the McCarran-Ferguson Act (MFA) in 1945, which partially exempted the insurance industry from federal antitrust regulation.[3]

[1]8 Wall. 168 (1869)

[2]322 U.S. 535 (1944). In this case, almost 200 fire insurance companies operating in six states were found guilty of "conspiring" to fix prices (through their trade association) in violation of the Sherman Antitrust Act.

[3]Boycotts, intimidation, and coercion on the part of insurance companies are still illegal under federal antitrust law.

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The intent of the MFA was to preserve the existing system of state regulation in insurance, a system not totally unwelcomed by various industry and state special interest groups (*The Pricing and Marketing of Insurance* 1977, p. 22). Explicit *state* ratemaking was already exempt from antitrust prosecution under the precedent set in *Parker v. Brown*.[4] But much of the actual state regulation of insurance (in 1945) was not explicit state ratemaking. Rather, it was a system of state-supervised *industry* ratemaking under the so-called prior approval approach. Insurers were allowed to set rates under the auspices of industry-owned rating bureaus that filed the rates for approval with the state regulatory authority. To preserve this regulatory structure in the wake of the *South-Eastern Underwriters* decision, explicit Congressional exemption from federal antitrust law was required. The prompt passage of the MFA supplied that antitrust immunity (for joint ratemaking) and sanctioned the continued state regulation and state taxation of P/C insurance.

There have been some fairly significant regulatory changes in the P/C industry since 1945. The most important change, propelled by the continuing growth of the direct writers of insurance (such as Allstate), has been the trend away from rigid, prior-approval pricing to so-called open or competitive ratemaking systems (MacAvoy 1977, pp. 18–22). Competitive ratemaking is still state supervised (this assures the MFA antitrust exemption), and rating organizations still exist to collect and collate industrywide loss data for members. But generally it is no longer mandatory that an insurance company join a rating bureau or abide by any statewide joint rate agreement. In most states, competitive rating implies that prices for insurance need be filed only with the state regulators; the rates themselves are determined by the carriers. Some competitive ratemaking states do not even require the public filing of some insurance rates; some states forbid rating bureaus from determining "prospective rates" (projecting past loss and expense trends into the future). Competitive or open rating systems of various types are now operative in almost two-thirds of the states in the more traditional areas of P/C insurance (Meier 1988, pp. 33–87).

The insurance industry's federal antitrust exemption can now be put in sharper perspective. The purpose of the antitrust laws, presumably, is to deter business practices (such as collusion) that might lower economic efficiency and harm consumer welfare. Since the states (which regulate insurance) have generally begun to move to competitive ratemaking, and since (as will be argued below) com-

[4]317 U.S. 341 (1943).

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petitive pricing in insurance appears to promote consumer welfare, why continue to exempt the industry from federal antitrust?[5]

Rivalry and Cooperation in Insurance

The essence of the debate over the possible repeal of the MFA is the controversial cooperative activity that occurs in insurance. Much of this intercompany cooperation occurs within the industry-owned and staff-operated ratemaking organizations. Industry rating bureaus consolidate industrywide loss data, perform various statistical and actuarial manipulations with the data (including the projection of past cost and expense information into the future), print rates and rating manuals, and file rates and rating plans with the various state-regulatory authorities. In addition to the rating organizations, there is substantial intercompany cooperative activity with respect to underwriting, reinsurance, participation in assigned risk pools and state guarantee funds, and the formation of various insurance pools and syndicates to write large risks. All of these activities and more (such as agreements with agents) are controversial from an antitrust perspective, and they would clearly come under Department of Justice scrutiny should the MFA be repealed (*The Pricing and Marketing of Insurance* 1977, pp. 167–88).

To understand the controversy over the application of the antitrust laws to an industry such as insurance, it is necessary to review briefly some basic economic theory (Asch 1983). Conventional competition theory holds that consumer welfare is enhanced by vigorous interfirm rivalry. Competition can exist whenever markets are easily entered, when products are relatively homogeneous, when market information is reasonably accurate and available, and when no one firm or group of firms can control the market price. In such markets it can be established that price will tend to equal marginal cost and, in equilibrium, minimum average cost (cost includes a reasonable rate of return on capital investment). In short, economic efficiency and consumer welfare are said to be maximized by vigorous business competition.

Competition (and presumably efficiency) can be compromised by the existence of monopoly power. Firms are said to have monopoly power whenever they are able to affect market price by restricting

[5]The National Commission for the Review of Antitrust Laws and Procedures recommended "that the current broad antitrust immunity for insurance should be repealed." See *National Commission for the Review of Antitrust Laws and Procedures* (1979, p. 227). Critics of the industry have recently recommended that the industry's antitrust exemption be re-examined. See *Hartford Courant*, 25 March 1988.

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market output. Presumably this economic power can be attained through internal growth, through merger with other firms, through interfirm collusive agreements to reduce output or fix prices, through product differentiation, or through various legal restrictions and barriers to entry. The effect of monopoly power, if exercised, would be to reduce consumer welfare (consumer surplus) and to misallocate scarce economic resources. The antitrust laws exist (purportedly) to maintain competitive markets and to deter the exercise of private monopoly power.

Rivalry in Insurance

The P/C insurance industry would appear to be "workably competitive," at least from a structuralist perspective (Joskow 1973), for the following reasons.

First, the product produced by the industry is relatively homogeneous, and has been standardized for easy buyer comparison by the industry trade associations and by state regulation. Product differentiation as a barrier to entry is not an important issue in insurance.

Second, there are thousands of P/C insurance companies, and state capital and surplus requirements do not appear to be overly restrictive of entry. In 1971 there were approximately 1,200 P/C companies in the United States (Joskow 1973, p. 379); in 1986, the number of companies had increased to approximately 3,600 (*Standard and Poor's* 1988). This strong increase in the number of new business organizations would indicate the absence of any substantial barriers to entry into P/C insurance.[6]

Third, concentration in the P/C industry is not high, especially when compared to levels of concentration in other U.S. industries. In 1986, for example, the four largest insurers received 22 percent of all premium income while the top 20 companies earned approximately 58 percent of all premium income. State Farm, the largest P/C company in the United States, had a market share of 8.8 percent in 1986; Aetna Life and Casualty, the fourth largest company, had a market share of 3.8 percent in 1986 (*Best's Review* 1987). By way of contrast, the top four cereal "breakfast food" companies in the United States generated 86 percent of that industry's output in the early 1980s. In primary aluminum, the largest four firms produced 64 percent of the industry's output. Even in the U.S. men's and boy's apparel industry—an industry noted for its intense competition—the

[6]Joskow (1973, p. 391) concluded that barriers to entry in insurance are "low," at least for agency companies. State capital and surplus requirements are generally not a significant barrier to entry. See *Monitoring Competition* (1974, p. 287).

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four largest firms sold 26 percent of the industry's output, a level of concentration that was higher than in P/C insurance (Bureau of the Census 1986).

Fourth, there is some evidence that the P/C industry has become slightly more concentrated recently. The largest 20 insurers did approximately 48 percent of the business in 1962, 54 percent in 1971, and 58 percent in 1986 (Joskow 1973, p. 381; *Best's Review* 1987). But this trend is not indicative of any decline in interfirm rivalry. Indeed, if anything, rivalry has increased in P/C insurance, and this has resulted in a slight overall increase in market concentration. The increased concentration is associated with the growth of the direct writers (such as Allstate) and the relative decline of companies that rely on the American Agency System.[7] It appears that industry resources are being reallocated from less efficient to more efficient business organizations, which is what one would expect from a competitive market process.

Finally, the great diversity of business opportunities in insurance, and the apparent absence of substantial economies of scale allow small, intermediate size, and large-scale firms to coexist and be rivalrous in the P/C insurance market.

By almost any structural measure, then, the P/C insurance industry would appear to be inherently rivalrous. There are no important structural factors that would appear to justify exemption from antitrust law or extensive state rate regulation.

If the P/C industry is inherently rivalrous, why is it regulated (at the state level) and why is it (partially) exempt from federal antitrust laws? State regulation of insurance and the antitrust immunity do not relate to the structure of the insurance market, but to controversies concerning the industry's historical *conduct* and *performance*. With respect to state regulation, the conventional wisdom is that the P/C industry was regulated (beginning in 1911 with the Merritt Committee Report in New York) because intense insurer/agent competition and even predatory practices threatened major insurer insolvency and put innocent policyholders at risk (*Monitoring Competition* 1974, pp. 9–13).

There is no reason to doubt that intense competition did exist in the 19th-century insurance industry. However, there is little empirical evidence to indicate that "predatory practices" made the industry generally unworkable.[8] Most of the insurer bankruptcies and insol-

[7]Direct writers underwrite and sell insurance products directly to buyers. Companies that use the agency system rely on independent agents to retail the insurance product.

[8]John Day (1970, p. 18) admits that there is "surprising little documentation to support the charges" (of predatory practices) in the famous *Report* of the Merritt Committee.

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vencies that did occur were associated historically with the occurrence of unpredictable natural disasters (earthquakes) or with poor business management, and not necessarily with agent-made destructive price competition.[9]

Furthermore, antitrust scholars are extremely skeptical of the theory and practice of so-called predatory pricing (Easterbrook 1981). Predatory practices are economically irrational in industries that have no substantial scale economies or other barriers to entry, and where the probability of achieving monopoly (with such practices) is low. In addition, solid historical examples of true predatory behavior in the U.S. business system are few and far between (Koller 1971). There is no reason to doubt that business rivalry in insurance was vigorous, but this vigorous rivalry was also tempered naturally by reason and by intercompany cooperative agreements. The precise origin of and justification for state regulation in insurance, therefore, remains undetermined.

Cooperation in Insurance

The real controversy in insurance is not over the nature of the rivalrous market process, but over the costs and benefits of intercompany cooperation—especially through ratemaking organizations. As we have noted, there is a long historical experience with interfirm cooperation in this industry, and the major justification for insurance regulation and its antitrust exemption relate directly to the alleged social benefit of that cooperation. Indeed, the MFA was passed in order to exempt (state supervised) intercompany cooperation (especially in joint ratemaking) from federal antitrust regulation.

There has always been a strong skepticism in the general industrial organization literature toward interfirm cooperation, especially if that cooperation might "affect" market output and price. Interfirm agreements often have been seen as collusive, as trade restraining, and as attempts to lessen competition and reduce consumer welfare (Bork 1966). Indeed, the per se prohibition of horizontal interfirm price and output agreements is the one remaining area of antitrust where there is still near unanimity that vigorous enforcement is still appropriate (Bork 1978).

[9]Studies of modern-day insolvencies confirm that "inadequate rates" are not (usually) the explanation for such difficulties. See *The Open Rating Law and Property Liability Insurance* (1977, p. 79); see also *Monitoring Competition* (1974, p. 387). Comparisons of states with open competition pricing and prior-approval pricing show no statistically significant difference in insolvency rates. See *Report of the Advisory Committee on Competitive Rating to the National Association of Insurance Commissioners* (May 1980, p. 28).

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There has been some recent academic discussion that has questioned the conventional wisdom concerning the per se illegality of horizontal business agreements (Dewey 1979, Armentano 1986). This discussion can be summarized as follows: In an uncertain world, it is not obvious that horizontal agreements lower social welfare. Horizontal agreements may reduce information costs, price-adjustment costs, consumer search costs, inventory costs, and business risk generally. If the probability of increasing price above competitive levels is reasonably low, the existence of the increased efficiencies associated with cooperation can enhance social welfare.

In order to "reduce costs," P/C insurance companies cooperate in a variety of ways. The most fundamental and controversial area of cooperation involves the collection and preparation of statistical data on industry loss experience. To see why this sort of cooperation is necessary for efficiency, consider that accounting costs for noninsurance companies are incurred in the present and are known at the time of contracting and price-making. The insurance business is fundamentally different. The primary costs of writing a fire insurance policy—the actual loss experience associated with that policy—cannot be known with complete accuracy until the policy expires, and perhaps not even then. But although future loss experience cannot be known in the present, it can be reasonably anticipated. A pool of historical data that encompasses a large number of relatively homogeneous units of risk exposure can provide a high degree of predictive accuracy with respect to future cost. And since individual firms are unlikely to have a large enough loss-experience base for accurate anticipation of future costs, the pooling of loss experience is essential for efficient cost estimation and ratemaking.[10] The more extensive the pooling, the greater the accuracy (presumably) in predicting costs, and the more efficient the industry will be (presumably) in tending toward an equilibrium price and output.

Rating Organizations

Rating bureaus are private organizations that collect loss-experience information from various insurance companies and perform various data manipulations. These organizations are owned by the insurance companies, managed by an independent staff, and licensed in the states where they operate. In prior approval states, it is common for the rating bureau to use loss data to prepare what are termed

[10]Some large insurers may have enough experience in some lines of insurance to develop credible rates. Most of the hundreds of smaller companies, however, do not have such experience. See *Monitoring Competition* (1974, p. 579).

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"advisory" rates for members, to file these bureau rates with the state regulatory authorities, to publish rating manuals, and to perform other various services for members. In "open competition" rating states, rating bureaus are generally not allowed to publish prospective rates or to require that member companies adhere to bureau-published prices.[11]

Supporters of rating organizations maintain that they provide essential services so that insurers can compete efficiently in the marketplace. Many hundreds of insurers are simply too small to have a loss (or expense) experience data base that would allow any accurate prediction of their future cost. Thus, the information provided through pooling is essential for efficient pricing. In addition, it is likely that there are substantial economies of scale in the collecting, filing, and publishing of information by rating organizations (*Monitoring Competition* 1974, p. 583). Some of these services could be provided by independent consultants on a contracting-out basis (MacAvoy 1977, p. 59), but the direct cost per unit of the service to the individual firms would likely be much higher. Most insurance companies (especially the medium size and small ones) choose to join and use the services of a rating organization even when such membership is no longer mandatory. This action is indirect evidence that the service cost to member companies (for discovering cost and price) is lower than it would be with some alternative arrangement.

In addition to explicit rating bureau coordination, insurance companies frequently form intercompany pools or syndicates in order to provide specific insurance coverage in high-risk areas. Syndicates are usually formed to spread the risk of providing extraordinarily broad coverage or insuring extraordinarily risky hazards, as in the nuclear fission and aviation industries. Insurance syndicates also exist to provide reinsurance and to allow small-company participation in writing risks that, on an individual firm basis, would simply be unavailable.

The formation of syndicates requires a high degree of intercompany coordination. Pools often require that members accept joint underwriting practices (classification, rates, rating plans), provide for the joint issuing of insurance policies, and provide for coordinated inspection and claim service. The provision of such coordinated activity allows the writing of insured risks that would otherwise not

[11]*Monitoring Competition* (1974, p. 576). On January 5, 1983, the Insurance Services Office (ISO) announced that it would develop "prospective loss costs" only in competitive rating states, and that this would tend to stimulate "independent pricing decisions" by insurers in those states (Caddy 1986, p. 175).

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be written at all (pooling increases "availability") or not written at the lowest possible cost. This would appear to be a reasonable conclusion given the inherent nature of some risks (as in aviation) and given the decentralized structure of the domestic insurance industry.

Antitrust and Cooperation: A Legal Analysis

All of this intercompany cooperation, and more, would come under antitrust scrutiny if the MFA were repealed. This scrutiny is likely since there is a long history of Department of Justice (Antitrust Division) interest in similar arrangements in other industries. In addition, there is a long history of antitrust cases where interfirm cooperative activity has been prosecuted, in many cases successfully.

The clearest and most obvious area of antitrust difficulty involves the determination of prices by the industry rating organizations. The current process of determining such rates would likely be construed as a "contract or combination in restraint of trade," as prohibited by section 1 of the Sherman Antitrust Act.[12] Business conspiracies that have the purpose or the effect of "fixing, stabilizing, or tampering" with market price (or even with a component of market price) are illegal per se, that is, they are illegal without any examination as to their alleged social "reasonableness." The per se illegality of price fixing agreements among competitors is the oldest antitrust legal principle and is firmly established in the law.[13] Section 1 of the Sherman Act and coordinated ratemaking in insurance are incompatible.

Even the collection of industrywide information (cost, sales, price) by a trade association and the use of that information by industry members is extremely controversial from an antitrust perspective. In *American Column and Lumber*,[14] for example, the Supreme Court condemned an industrywide trade association that had provided past price and sales information to members, and had made suggestions as to probable future prices and production levels for the industry as a whole. An even more restrictive ruling was made in *American Linseed Oil*[15] where just the collection of past information on costs

[12]"The existence and practices of rating organizations directly conflict with antitrust concepts. . . . When such activity results in advice or suggestions concerning price, it is likely to run afoul of the antitrust law" (*Monitoring Competition* 1974, p. 577).

[13]United States v. Trenton Potteries Co., 273 U.S. 392 (1927); United States v. Socony Vacuum Oil Company, 310 U.S. 150 (1940); United States v. Masonite Corp., 316 U.S. 265 (1942).

[14]257 U.S. 357 (1921).

[15]262 U.S. 371 (1923).

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and prices was enough to condemn the arrangement. In *Maple Flooring*[16] and *Sugar Institute*[17] the Supreme Court attempted to make a clear distinction between a trade association that simply provided past information on prices—presumably legal—and an industrywide agreement to adhere to future price announcements—which was illegal per se. Yet that distinction has been blurred recently. In *Container Corporation*[18] the Court concluded that the reciprocal exchange of past price information between two different companies had the result of stabilizing future prices—admittedly in a downward direction, so that the exchange was declared illegal per se. (The container industry was highly concentrated.) This extreme approach was reaffirmed in *U.S. v. United States Gypsum Company et al.*,[19] where an intercompany exchange of price information—allegedly to better comply with the provisions of the Robinson-Patman Act—was declared illegal per se.

Some recent Supreme Court decisions concerning price agreements may have softened somewhat the per se prohibition. This change is most obvious in *Broadcast Music, Inc. v. CBS, Inc.*,[20] where the Court was persuaded that the overall efficiency of "blanket licensing" of copyrights outweighed the elimination of some price rivalry. The Court voted (8–1) to reverse a Second Circuit decision, which had found the licensing agreement illegal per se, and remanded the case for further consideration under a rule of reason. The complaint was ultimately dismissed.

In *Maricopa*,[21] however, maximum-fee schedule agreements among doctors were held to be unlawful per se even though the agreements clearly created information economies that would benefit consumers. And most recently in *NCAA v. Board of Regents*[22] the Court, while accepting a rule of reason approach to NCAA controls on the licensing of college football rights, decided that the specific controls involved here were unreasonable and illegal under the Sherman Act.

This brief review of the case history makes it clear that many of the most important activities of rating organizations in insurance would appear to be in direct conflict with antitrust law. Bureau organizations that collect historical loss and expense data, that project such

[16]268 U.S. 563 (1925).
[17]297 U.S. 533 (1936).
[18]393 U.S. 333 (1969).
[19]438 U.S. 422 (1978).
[20]441 U.S. 1 (1979).
[21]457 U.S. 332 (1982).
[22]468 U.S. 85 (1984).

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data forward in time, and that formulate prospective or trended average rates for members would likely be engaged in an activity (without the MFA) that would violate the antitrust laws.[23] Even if a rule of reason were applied in such cases, this sort of activity would likely be judged an unreasonable and illegal restraint of trade.

Other Antitrust Problem Areas

There are several other intercompany activities that likely would be misunderstood, and might well be restricted, if the federal antitrust laws were applied to P/C insurance. One of these areas involves so-called restrictive underwriting where insurers—because of the existence of indeterminate or unacceptable risks—decide to restrict coverage or even eliminate coverage to selected individuals, firms, or governmental agencies. Recently there has been much discussion of a national "tort liability crisis," and of the restricted availability of insurance (or sharply higher rates) for risks associated with toxic wastes, product liability, day-care, and many other activities (Huber 1988). If this restricted availability of insurance (or higher rates) is accomplished through the auspices of an important industry rating bureau, such cooperative activities could well be seen as an illegal restraint of trade. Indeed, several states have recently brought a major antitrust suit against several large insurers and the most prominent industry rating bureau (ISO), claiming precisely such an illegal restraint (*Wall Street Journal,* 23 March 1988).

It is also quite common for insurers to cooperate and develop "assigned risk" plans where certain types of insurance (auto) are required by state law, and where industry underwriting standards may have restricted the availability of insurance. These assigned-risk plans and jointly determined rate schedules for insurance could be of concern to the Department of Justice if the MFA were repealed.

Also of interest to the federal trust-busters would be insurance company participation in state "guaranty fund" associations. Guaranty funds, mandated in many states, allow some insurers to monitor the economic performance of other insurers in order to determine whether their financial condition is "hazardous" and merits state regulatory remedial action.[24] Such coordinated activities, where competitors can make recommendations concerning the economic solvency of rivals, and where they can make recommendations for gov-

[23]This was the Department of Justice's opinion in 1977. See *The Pricing and Marketing of Insurance* (1979, p. 169).

[24]Insurers contribute to guaranty funds and the proceeds can be used to pay the claims of insolvent insurers.

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ernmental intervention, may well contain some inherent antitrust difficulties.

There may also be some potential antitrust difficulties in the business relationship between some insurance companies and the "independent" agents that sell insurance (*Monitoring Competition* 1974, pp. 544–45, 557–58). These contractual agreements frequently contain "volume requirements" for the allocation of business among insurers; these volume requirements might be seen as a kind of "division of market" agreement that violates the antitrust laws. In addition, it is not uncommon for insurers to require independent agents to write a "balanced book" of business, that is, to tie profitable insurance products to other more risky or less profitable insurance products. Such agreements might be challenged under section 3 of the Clayton Act, which outlaws tying agreements that may tend to lessen competition substantially. Finally, most commercial insurance is written at rates that are freely negotiated, and such rates might violate the Robinson-Patman Act's strict prohibition against price discrimination. These represent only some of the likely flash point areas where there may be antitrust liability for insurers, especially in private suits, if the MFA were repealed.

The Antitrust Laws and the Insurance Industry

Should the federal antitrust exemption for insurance be removed? An earlier study (Brainard and Dirlam 1966) replied negatively but a more recent analysis (*National Commission* 1979) answered clearly in the affirmative. The antitrust laws, especially the Sherman Act of 1890, purportedly exist to promote business competition and deter the existence of monopoly power. These laws are said to enhance free and fair competition, and to ensure that scarce economic resources are employed in a manner that tends to maximize consumer and social welfare. Since the state regulation of insurance is moving toward competitive pricing (this has slowed recently), why retain the industry's federal antitrust exemption?

There are at least four *general* reasons why the federal antitrust laws should not be extended to currently exempted industries such as insurance.

First, enforcement of the antitrust laws in other industries has frequently misconstrued the true nature of competition and monopoly power. Business competition is a dynamic discovery process under conditions of uncertainty that can include interfirm rivalry as well as interfirm cooperation; it is not an equilibrium condition, and the equilibrium economic models are misleading in that regard (Kirz-

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ner 1973). Accordingly, a business organization's market share is not an indication of its market power but is, instead, an indication of its relative efficiency vis-á-vis other business organizations. Monopoly power, correctly understood, is to be associated with governmental restraints on rivalry or cooperation, and not with strictly free-market activity (Rothbard 1962).

Second, the history of antitrust enforcement reveals that the laws have been employed frequently to shelter and protect less-efficient business organizations from the rigors of the free-market competitive process. This protectionism is most obvious in the private cases where one firm sues another (95 percent of all antitrust litigation is private), but it is also evident in many classic government cases as well (Armentano 1982).

Third, antitrust regulation is a kind of government "industrial planning." It has been employed to raise or lower market prices, to break up companies, to end voluntary contractual agreements, and to prohibit mergers. Yet such decisions, to be rational, presume that the regulators or the courts can have access to economic information concerning social costs and social benefits that, it can be argued, are simply unavailable in the absence of a spontaneous market process. Antitrust is government regulation and is subject, therefore, to all of the general criticism of government regulation and planning in the literature (Poole 1983, Lavoie 1985).

Fourth, the antitrust laws are a civil liberties nightmare. The laws have been enforced arbitrarily, often violate conventional notions of due process of law, and always interfere with the legitimate natural rights of property owners. As Adam Smith observed more than 200 years ago, laws (such as antitrust) that interfere with voluntary and cooperative social activity cannot be made "consistent with liberty and justice" (Smith [1776] 1937, p. 128).

In addition, there are a number of *specific* reasons why the insurance industry's antitrust exemption should be retained. The most important reason is that ending the exemption would not increase efficient competition. It would tend to increase short-run firm rivalry—one aspect of competition—but it would lead to a substantial decrease in interfirm cooperation, the other essential element of efficient competition in this industry. As noted, there is substantial intercompany cooperation in insurance that promotes low costs and effective rivalry between companies of various sizes. If this essential cooperation were severely curtailed through antitrust regulation[25] (litigation or

[25]It has been recommended that certain specific collective actions be permitted by statute in lieu of the current blanket antitrust immunity. But there is no clear consensus

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the threat of litigation), it is likely that the costs and prices of insurance services would increase, and there would be a strong incentive for industry consolidation through merger. Higher costs and increased market concentration would be the likely consequences of repealing the insurance industry's antitrust exemption.

Supporters of antitrust regulation in insurance have argued that the antitrust laws would not be used to attack efficient practices (such as information sharing and coordination) that lower industry costs (MacAvoy 1977, pp. 52–55). But the history of antitrust enforcement suggests that we maintain an extremely skeptical position with respect to such assurances. The fact remains that both government and private litigants have employed antitrust regulation against efficient business conduct and performance. Such conduct on the part of defendants in antitrust cases has often been termed (by the courts) "exclusionary" of less-efficient business organizations, and has frequently resulted in antitrust liability for defendant companies. Indeed, some of the most important and classic legal actions in antitrust history have been brought against business organizations that have lowered prices and increased market outputs (Armentano 1982). Firms that are truly inefficient tend to lose market share, and are rarely the focus of any antitrust attack.

Insurance and the Critics

Supporters of antitrust regulation in insurance have argued that intercompany cooperation—especially through rating bureaus—can lead to less availability and sharply higher prices for insurance services. They have identified some recent examples in auto insurance and in liability insurance generally where insurer rates have risen dramatically, or where traditional liability coverage has become almost impossible to obtain. They suggest that the application of antitrust to these situations would end insurer collusion, increase availability, and lower insurance rates (*Hartford Courant*, 23 March 1988).

There are at least two responses to such charges. The first is that the hefty increases in insurance prices recently (or sharply restricted availability) is the likely competitive consequence of a radically changed expense or loss-experience data base. While the industry in the 1980s has remained generally profitable due to its investment income, it has shown a vast underwriting loss on its property-liability

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on which specific collective actions promote the "public interest." See *National Commission for the Review of Antitrust Laws and Procedures* (1979, pp. 236–45) 2nd *Report of the Advisory Committee on Competitive Rating* (1980). For a recent discussion, see Kouatly (1988).

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insurance business.[26] Prices for P/C insurance have not generally been sufficient to cover the sharply higher costs of claims, especially in auto and workmen's compensation. Tort liability has been expanded by judicial reinterpretation (Huber 1988) and the insurance carriers have experienced or expect far higher costs than they anticipated when these policies were first written. Even with an industry fully subject to antitrust regulation, court-broadened tort liability would eventually have produced restricted underwriting practices and caused a substantial increase in rates (Priest 1987). It is not necessary to assume illegal insurer collusion to explain recent policy and pricing practices in this industry.[27]

The critics mistake the inherently cyclical price and profit performance of the insurance industry for monopoly power. When the market demand for insurance is strong and when interest rates are low, prices for insurance can be maintained or even increased. But stable insurance prices in one period always encourage an increase in capacity in the next period, and intense price competition becomes inevitable. This down-cycle was especially evident in the late 1970s and early 1980s when insurance firms scrambled for each and every premium dollar in order to invest at high interest rates. When interest rates declined, and when judges and juries dramatically increased the cost of future insurance claims, insurance availability was again restricted and prices increased. Prices in the late 1980s are again moderating somewhat as significant new capacity reaches the market. But all of this is supportive of the notion that the industry is workably competitive, and that there is no monopoly power in insurance.

The second response to the charge that the industry has functioned monopolistically is that the structure, conduct, and performance of the industry appear workably competitive (Joskow 1973). The P/C industry is extremely decentralized and there are few nonlegal barriers to entry. Profitable prices for insurance in one period lead to increases in capacity and to a moderation in prices in the next period. Higher claim costs (realized or reasonably expected) and lower interest rates lead to reduced availability and to higher prices. These are

[26]*Best's Review* (January 1988, p. 26) reports an underwriting P/C loss of $13.3 billion in 1983, $21.5 billion in 1984, $24.8 billion in 1985, $15.8 billion in 1986, and an estimated $9.8 billion in 1987 for a total five-year statutory underwriting P/C loss of $85.2 billion.

[27]The recent state antitrust suits allege that several major insurers illegally pressured the Insurance Services Office (ISO) and its members to adopt more restrictive ("claims made") liability policies. See *Wall Street Journal* (23 March 1988). (The companies involved have denied the allegations.)

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competitive responses and not necessarily evidence of any monopoly power or inefficiency.

This is not to assert that the P/C insurance industry in the United States is beyond criticism. Since the industry is inherently rivalrous, and since intercompany cooperation is essential to efficient operation, there is little economic justification for the traditional crazy-quilt pattern of state regulation. The bulk of these state regulations likely create an artificial product uniformity, temper the price rivalry emanating from the aggressive direct-insurers, and generally reduce consumer welfare (Ippolito 1979, Frech and Samprone 1980). Since the long-term trend in this industry is toward open rating, the bulk of the state regulatory structure that inhibits insurer price and product rivalry or cooperation—essentially a holdover from prior-approval ratemaking—should be abandoned.[28] The insurance industry at the state level should be deregulated in much the same manner as the transportation industry has been deregulated, and for precisely the same economic reasons. Deregulation in insurance, and the retention of the industry's antitrust immunity, would allow the suppliers of insurance to generate a market-determined mix of rivalry and cooperation that is essential to efficient service in this industry. That competitive mix, unknowable ex ante to any economist, regulator, or court, should be determined through an open-market competitive process and not by state or federal regulation.

The New Antitrust Skepticism

Deregulation in insurance and the retention of the industry's antitrust exemption fit in with recent public policy experience in other industries. The consumer gains associated with deregulation in railroads, trucking, and airlines (Morrison and Winston 1986) have been impressive. Moreover, during the 1980s, an important new skepticism concerning "traditional" antitrust enforcement has developed. Some antitrust scholars and administrators have argued that less, not more, antitrust enforcement will improve industrial efficiency, productivity, and competitiveness (England 1985). Critical enforcement areas have been criticized severely, and the new skepticism (the "new learning") has resulted in some modest changes in the enforcement of antitrust law in the 1980s. Merger guidelines have been liberalized and a vigorous market for corporate control has developed. Certain tying agreements and so-called restrictive practices (such as resale price maintenance) are no longer regarded by some

[28]Instead of state deregulation, some analysts have argued for a broadened state regulation that would include the insurance industry's investment income (see Caddy 1986).

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reputable antitrust scholars as per se harmful.[29] Price discrimination cases have been curtailed dramatically since it is difficult to understand how prosecuting firms that charge lower prices promotes the public interest. Efficient business organizations that grow internally to achieve higher market share are no longer inevitable antitrust targets. Finally, there is even some serious academic skepticism concerning the current per se prohibition of horizontal agreements. If the risks to consumers are minimal, and if the agreements promise substantial cost savings, horizontal agreements can advance the "public interest" and can be permitted (Smith 1983, Armentano 1986). This line of reasoning is directly applicable to P/C insurance.

The antitrust policy skepticism of the 1980s is the result of a number of different factors. There has been an increasing realization recently among economists and others that specific business practices, once regarded as elements of monopoly power, may actually enhance efficiency and the competitive market process. There was a time in antitrust economics when almost any deviation from the purely competitive model was seen as "resource misallocating" and as a justification for stricter antitrust enforcement (Wilcox 1966). But deficiencies in the purely competitive model (as a welfare paradigm) have now been widely acknowledged, especially with respect to how actual business organizations efficiently adjust to economic uncertainty and change. Market output is no longer thought to be restrained inefficiently by product differentiation, or economies of scale, or by "restrictive" practices such as tying agreements.

Attitudes toward merger and increasing market share have also changed somewhat over the last 10 years (Brozen 1982). Economists now recognize that business organizations which are relatively more efficient than their rivals (or potential rivals) will tend to grow faster than their rivals, and will earn an increasing market share. Increasing market concentration that is the result of innovation and increased resource efficiency can be beneficial to consumers. In the absence of legal barriers to entry, it is not apparent why government antitrust regulation ought to interfere with such a benign market process.

Another important reason for the new antitrust skepticism is antitrust case revisionism. Prior to 1975 there was a widespread impression within the antitrust establishment that an impressive body of evidence existed that supported traditional enforcement policies. The laws had been enforced, presumably, to deter firms from reducing output and raising market prices. Yet this "public interest" theory of antitrust enforcement has come under increasing criticism

[29]Continental T.V. Inc. v. GTE Sylvania, Inc., 433 U.S. 36 (1977); see also Posner (1981).

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(DiLorenzo 1985). Most of the important case evidence demonstrates, contrary to the conventional wisdom, that many of the indicted business organizations had expanded market output and lowered market prices, and that trade had generally not been restrained (Armentano 1982). Antitrust, especially in the private cases, may have been employed as a club in an attempt to restrain the rivalry of more-efficient defendant business organizations and to allow less-efficient business plaintiffs to earn economic rents (Baumol and Ordover 1985). If this is the manner in which antitrust has actually worked in practice, it is hardly the sort of public policy that one would want extended willy-nilly to an industry such as P/C insurance.

Conclusion

Continuing to exempt the P/C insurance industry from antitrust regulation is consistent with the new skepticism concerning the social value of strict antitrust enforcement. It would appear especially inappropriate to extend the reach of the antitrust laws to an entirely new area (insurance) at the very time when the theory and practice of such laws are being seriously questioned in traditional areas of enforcement. The most intelligent public policy in insurance would be to continue to deregulate the P/C industry at the state level by removing all legal restrictions that deter competitive rivalry or cooperation, and to maintain the current McCarran-Ferguson Act exemption from federal antitrust law.

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Taxation, Political Action, and Superfund

Bruce Yandle

Introduction

There is little argument with the statement that people are purposeful economic agents. On the basis of our many observations and introspection, we know that regulatory institutions are designed by people inspired to accomplish specific implicit and explicit goals. Yet our personal experience in building incentive systems and regulations, whether for our children, students, or employees or in government and business, teaches us that the regulated often surprise us. Like all human beings, regulated people attempt to make the best of the situation in which they find themselves. They are also active participants in the design, implementation, and enforcement of rules.

Asserting that economists agree with these statements is another way of saying that they are social scientists who attempt to explain behavior of acting and reacting human beings as best as possible. However, past violations of this canon of the social sciences have produced faulty predictions for the outcomes of many policy prescriptions.

Recommendations for the design of economic incentives for the purpose of internalizing external effects, an approach that generally warms the cockels of economists' hearts, is a prime example of analytical failure. The general failure to anticipate outcomes when fees and charges are implemented may reflect the fact that we are blinded by their market-like qualities and therefore fail to consider two important analytical features of the devices. First off, we fail to account

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for the adjustments made by those who will pay the charges. This shortcoming leads to a second failure: We pay too little attention to the political economy—the public choice—dimensions of the regulatory institution.

This paper examines environmental taxes from a public choice perspective. It has three major sections. The first section reviews an old controversy inspired by A. C. Pigou's (1920) admonition regarding social cost and user charges, one that was joined by Turvey (1963), Buchanan and Stubblebine (1962), and Coase (1960). That controversy reveals early elements of a public choice analysis that causes most systems of user fees to be unstable. The second section examines more recent contributions by public choice economists that help to explain why user fees are often politically unattractive.

The third major section considers the U.S. Environmental Protection Agency's (EPA's) Superfund program for clearing away hazardous wastes, a program funded primarily by taxes indirectly linked to the production of hazardous wastes. The discussion in that section identifies institutional details that follow public choice predictions found in the first two sections.

Before Public Choice: Pigou and the Revisionists

The Pigouvian Prescription

A. C. Pigou (1920) is immortalized by a tax bearing his name, a tax designed to adjust the behavior of economic agents who impose more cost on society than they recognize in their decisionmaking. Pigou's argument goes like this: If the all-knowing economist finds a situation where private cost is not equal to social cost, a proper equilibrium can be attained by taxing the producer of the social cost at an amount equal to the previously unrecognized marginal cost imposed on society.

Like other efficiency-based arguments, Pigou's prescription sparkles with morgue-like logic. If politicians are all dead, and if rigormortis has set in and frozen the relevant supply and demand curves, the prescription will work. Efficiency will be attained just as surely as the solar system will move in predictable ways.

Pigou's argument from the 1920s about smoke control continues to be repeated to this day. For example, a recent item in *Regulation* magazine (1988, p. 5) put the argument this way:

> If the EPA decides to limit lead in gasoline, or acid rain, or chlorofluorocarbons, then user fees are an efficient solution. They force firms to pay for the damage done to the environment or for the scarcity value of the resources they consume.

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The Revisionists

But reactions to the analytics of environmental user fees identified some fatal flaws. First off, Turvey (1963) described postequilibrium bargaining, the situation that occurs predictably after the appropriate Pigouvian tax is placed on the producer of specified emissions (smoke) that can be monitored. Allow me to couch Turvey's argument in the language of political economy.

At the outset, a tax on the specified smoke cannot develop until politically effective people demand action. Assume there is political pressure, lobbying, or some other costly political-influencing activity, which some term reactions to social cost. Said differently, there are private individuals who demand political action in the form of an environmental tax. The effects of the noxious smoke on these people and their economic fortunes are normally shown as a rising marginal cost that is not registered in the firms' decisionmaking. Given the identification of that cost function, the all-knowing Pigouvian-trained economist calculates the appropriate marginal tax and the politicians—seeking to serve the public interest—impose the tax on smoke-producing firms. The equilibrium is achieved where marginal social cost is equal to the firms' demand for getting rid of smoke. The firms' demand for alternative smoke removal services becomes meaningful when it is likely that an environmental user fee will be charged.

But Turvey tells us this equilibrium will not hold. To demonstrate the point, he subtracts the marginal tax from the firms' demand for smoke emissions, giving a net marginal benefit curve. Just as Pigou and the recent writer in *Regulation* indicate, the polluting firms produce to the point where the net marginal benefit is zero. Returning to the demanders for political action, Turvey reminds us that individuals will seek reductions in pollution until the net marginal benefit to them from doing so is also zero. While lobbying activity is no doubt costly, those demanding political action do not face a marginal tax for each unit of emission reduced. But suppliers of smoke must pay an incremental fee.

In the small numbers setting contemplated by Turvey, the demanders of environmental purity want even more smoke reductions, once the Pigouvian tax is put in place. When lobbying costs are introduced to Turvey's analysis, it is possible that the demanders of purity will be satisfied with a smokey world. They will undertake lobbying actions so long as there are gains from doing so.

Without addressing institutional arrangements and the necessary political intermediaries, Turvey couches his behavioral analysis in terms of postequilibrium bargaining, where the polluter is bribed to

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reduce pollution beyond the amount that coincides with the Pigouvian tax. He indicates that a suboptimal amount of smoke will be produced. In this setting, environmentalists demand more purity than Pigouvian politicians provide. Introducing a costly political mechanism where purity lovers must compete in a political economy with industrialists and an unorganized but nonetheless important group of consumers and taxpayers obviously brings discipline to the analysis.

James M. Buchanan and William Craig Stubblebine (1962) also participated in the pre-public choice fray and carefully defined and analyzed externalities for us. Dressed in efficiency-enhancing clothing, they went on to describe an appropriate equilibrium in a world where smoke producers valued the opportunity to discharge and receivers of smoke suffered economically from its production. Their prescription implied that a Pigouvian tax should be imposed on both sides of the transaction, a point enlarged upon by Hugh H. Macaulay (1972). If the receivers of smoke, just as producers, have to pay for marginal benefits they obtain—an improvement in their environment and the rents that accompany it, their demand will be satisfied by the appropriate user fee. There will be smoke in the final equilibrium, but there will be no postequilibrium bargaining.

Theoretically, at least, Congress can impose the appropriate tax on all parties and, having performed that miracle, go on to do greater things. Following the final resolution of the problem, the environmental lobbyists will retire. Of course, we have yet to hear of a bilateral user fee. We are more disposed to think in terms of right and wrong, somehow knowing that smoke producers are wrong and must be punished. Oddly enough, it seems, we do not usually react that way when multiple parties desire competing uses of food, land, automobiles, and a host of other scarce and life-sustaining resources. People who purchase those goods for consumption purposes pay the posted price. Those who purchase the goods to reserve them for the future or forever must also pay.

Finally, Ronald Coase (1960) became as famous as Pigou, if not more so, for his contribution to the debate. Under theoretical circumstances less severe than those specified by Pigou, Coase argued that social cost just does not exist in a world where contracts can be written and property rights defined and enforced at negligible costs. All problems of social cost are really private problems. If there is a problem labeled social cost, such as an abundance of smoke, it implies either that property rights will soon emerge and opportunity costs along with them or that the cost of internalizing the external effect is just too high.

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One interpretation of Coase's theoretical point implies that it is better to bear the cost of living with or avoiding the smoke than to incur the resource cost of controlling it. Another interpretation asks that the cost of exercising government's police powers be compared with the private transaction costs for dealing with the problem. If the cost of government regulation is less than private party bargaining costs, a case is made for environmental regulation, where government becomes the implicit owner of certain rights to the use of a resource. In effect, a new landlord enters the picture.

The Diagrammatic Treatment

The analysis contained in this review is illustrated in Figure 1, which contains the familiar marginal benefit, MB, from discharge by the polluter, and the marginal cost, MC, imposed on smoke receivers. Pigou calls for a marginal tax, T, to be imposed on the polluter, anticipating an equilibrium quantity of smoke, OE.

Turvey's net marginal benefit, NMB, function is also shown in the figure, along with the implied final equilibrium quantity, OB. Following Turvey, the polluter pays OTAE in taxes and receives up to BCAE in bribes for postequilibrium adjustments. However, political economy suggests that payment would go to politicians or at least be shared with them.

The diagram also shows a bilateral tax, with T imposed on polluters and T' charged the demanders of smoke reduction. The equilibrium OE holds in this case. There is no economic force calling for further adjustment.

With some imagination, we can explore what happens when the purity demanders face explicit lobbying costs. Introduction of a constant marginal lobbying cost, MLC, function and subtracting it from MC, which is the inverse of the smoke receivers' marginal benefit curve, yields MC', a net marginal cost function. The intersection of MC' and NMB yields another equilibrium solution, with OD amount of smoke being emitted. Unless misguided, the demanders of purity would not engage in costly lobbying if that activity brought less smoke reduction than was attained with the tax and no lobbying activity. We also can picture what might happen if government subsidizes the purity lovers while taxing the polluter. The adjusted net MC curve would shift to the left, calling for more reductions.

But why might the government choose to use some of the user tax revenues, or other revenues, to subsidize the purity lovers? The purity lovers can identify new pollutants or new dimensions of the old pollutant and thereby strengthen the regulatory hand of government. If government announces that additional features of smoke

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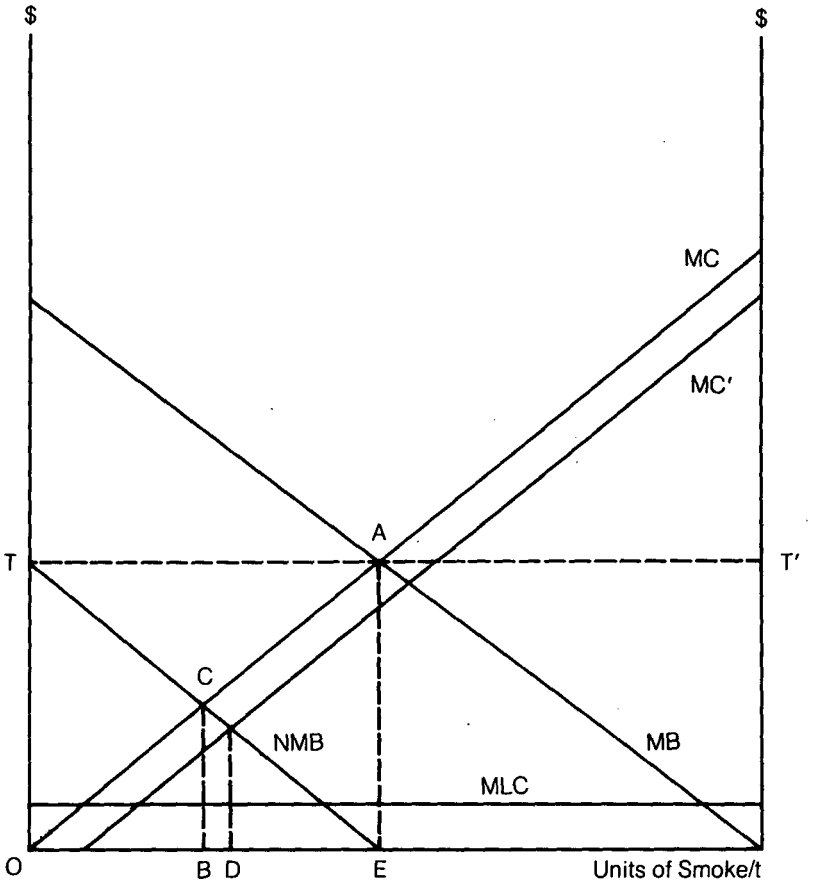
FIGURE 1

ANALYSIS OF USER FEES



discharge are to become subject to taxation, that brings an addition to the polluters' marginal benefit function. (The polluter must either change its production technique, for example, or discharge and pay the tax.) An increase in the marginal benefit function can allow for increases in the Pigouvian tax, or at least generate more revenues from the current tax. An interesting interaction between user charges and regulation results from all this, with revenues becoming an important feature of the analysis. However, the active participation and resistance of the regulated, a point to be introduced later, further complicates the analysis.

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The Revenues

It is interesting that what becomes the more salient part of the user fee question from a public choice perspective—the revenues and what might be done with them—is generally dismissed in the debates about the fees. Efficiency analysts see revenues as a totally different question, even unrelated to the central point about the merits of the fees themselves. But public choice economists expect politicians to assign a positive value to alternative tax revenues, especially in an age of government deficits and public opposition to direct taxation. Given constraints on the normal means of taxation, the mistaken efficiency trait of user fees can be put forward in efforts simply to find more money to fund special interest programs. Once the fees are in place, the politicians will predictably seek ways to increase demand for the fee-generating activity.

Of course, neither Pigou, Buchanan-Stubblebine, Turvey, nor Coase were reflecting on the literature of public choice when they prepared their analyses of user fees. They could not, since the literature did not exist. As it turns out, Pigou's prescription suffers under public choice scrutiny. Buchanan-Stubblebine's point continues to hold water, as do the insights of Coase and particularly Turvey, since his analysis predicted human behavior in the political setting. At best, however, the valuable public choice insights registered in those earlier years were important scratches on the surface of the problem.

New Public Choice Perspectives

Deeper analytical cuts were made when public choice economists began to investigate why user fees are seldom used. Widely advocated by economists, efforts to impose a tax on the sulfur content of coal, so as to reduce sulfur dioxide emissions, by the Nixon administration were frustrated by congressional committees (Downing 1984, pp. 211–12; Irwin and Liroff 1974, pp. 126–34). Environmental issues were handled by the Public Works Committee while the Ways and Means Committee dealt with taxes, and both committees had bigger fish to fry.

Buchanan and Tullock (1975) pointed out why none of the demanders for control, the ones who might have lobbied the Public Works Committee, wanted taxes. Spokesmen for industrial firms knew they were against taxes on pollution. Already being required to install pollution control devices, they wanted subsidies. As they saw things, placing a tax on postcontrol pollution added insult to injury. The Ways and Means Committee sympathized. Its members did not want to see a more valuable tax initiative become bogged down in debates

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about pollution taxes. The politicans could arguably earn more rent dealing with income tax reform than from a small-fry sulfur tax on the burning of coal.

But what about the technology-based regulation that ultimately became the flagship of American environmental regulation? Why did the environmental lobbyists not go for Pigouvian taxes? Heavily funded by EPA, the environmentalists worked for rules that promoted the agency.[1] Taxes collected by the IRS do not. Popular rhetoric at the time added a nice veneer to their arguments. User fees were described as giving a license to pollute. Since zero pollution was the official goal, why fool around with taxes, unless the taxes were high enough to reduce pollution to zero (U.S. Congress 1971).

But there is more to the story. As Buchanan and Tullock tell us and later empiricists reveal (Maloney and McCormick 1982), industrialists can gain from command and control regulation. This regulation turns existing firms into cartels by limiting entry and coordinating output across firms in the same industry. Sadly for special interest groups, user fees tend to maintain competition and generate no rents for industrialists. If there is to be environmental control, the industrialists predictably side with the environmentalists and call for command and control. Like bootleggers and Baptists, the two groups argue separately for rules that restrict output.

The case for revenue-generating user fees is weakened significantly by three distinctly different forces. First, environmentalists view the sale of the right to pollute as being immoral. Second, as cost minimizers, industrialists have nothing to gain by paying more taxes, but can gain from technology-based standards that restrict entry and raise competitors' costs. Finally, political agents can gain by providing regulatory outcomes that are valuable to environmentalists and industrialists.

There are two additional public choice explanations of why command and control regulation is preferred to economic incentives, such as user fees. Viewing Congress as a rent-maximizing organization, Fred McChesney (1987) has shown how political bodies will logically propose regulations that inspire affected groups to organize and lobby against the rules, thereby increasing their support of the relevant politicians. Once the rules are in place, McChesney argues, Congress can play the same game in reverse, in effect auctioning off regulatory reform to members of the same group. His analysis suggests Congress would entertain the use of environmental user fees

[1]For pertinent details on this, see Downing (1984, pp. 263–68) and Bennett and Dilorenzo (1985, pp. 137–72).

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and in doing so extract payments for moving away from that mechanism. Once command and control regulation is in place, Congress can gain political contributions by tinkering with the rules.

Yandle and Young's (1986) analysis of environmental regulation supports the McChesney argument. They argue that the current practice of command and control regulation is highly discriminatory across firms, industries, and regions. The actual rules are designed for industry subcategories, have different levels of stringency, and have varying levels of enforcement. Congress can price-discriminate across firms as though the rules were being auctioned to political agents.[2] Pigouvian taxes, on the other hand, tend to be uniform, and the IRS is generally interested in collecting taxes, not campaign contributions.

The political bargaining discussed here does not take place in a fiscal vacuum. The general populace may suffer from fiscal illusion, but at some margin we would expect all interest groups to become aware of the deadweight loss, and loss of revenues, associated with the regulatory institutions that emerge. Given competing and growing demands for government services and the relative burden of existing taxes, Congress would find occasions where command and control regulation would be modified and augmented by user fees. However, public choice predicts that the tax revenues will then be used in strategic ways to reward special interest groups and the political brokers who serve those interests.

In summary, several propositions unfold from a public choice analysis of environmental taxes:

- Unilateral taxes for controlling external effects will not generate a stable equilibrium in a political economy.
- Command and control regulation will generally be preferred to taxes and other economic incentives.
- When used, taxes on environmental use will be applied in ways that inspire the organization of interest groups who then support the expansion of bureaucracies.
- Revenues from environmental taxes can be important enough to overcome their otherwise unattractive features, especially when the fees are included in a regulatory package.

Superfund and User Fees

Congress does occasionally apply taxes to environmental control problems. Such a scheme is found in the Superfund program. Super-

[2]A related argument is made by Pashigian (1982) regarding the political use of environmental regulation to affect regional development and the protection of industry in one location from competitive entry and exit.

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fund was established when the Comprehensive Environmental Reclamation and Cleanup Act was passed on December 11, 1980 (*Environmental Law Handbook* 1985). It is important to recognize that the legislation established a regulatory scheme that included a $1.6 billion cleanup fund that was to receive 87.5 percent of its revenue from taxes on petroleum stocks and 42 specified chemical feedstocks. The balance was to come from general revenues.

The Pigouvian Logic

The logic of the feedstock tax was partly Pigouvian, at least in its origins. In March 1979, before debating the control of hazardous wastes and passing the Superfund legislation, Congress had been considering a proposal from the U.S. Coast Guard to place a tax on imported oil that would account for the external costs imposed when oil spills occurred into coastal and inland waters.[3] Going beyond the Pigouvian prescription, the proceeds from the fee were to go into a fund that would then be used to repair damages and compensate damaged parties, so as to eliminate litigation. At about the same time, Love Canal entered the picture and EPA joined the Coast Guard and the U.S. Justice Department in recommending a larger fund.

In a purely theoretical way, the underlying notion for producers of chemical wastes was straightforward: The early hazardous waste products found in unmanaged, mismanaged, and neglected dumps are the result of chemical production. The producer unwittingly imposes costs on society that are not included in the prices paid for inputs. Taxes based on production will fund necessary future cleanup actions that restore the affected sites. In this somewhat tortured sense, the taxes indirectly cause firms to recognize external costs imposed on innocent third parties.

Missing the Pigouvian Mark with Political Economy

While the Superfund tax concept appears to follow Pigouvian logic, its design misses the mark. The tax is not a user fee set equal to marginal social cost generated by any particular producer. In fact, all producers using the same feedstocks pay the same marginal tax rate without regard to their present and past behavior. The cleanest and most careful chemical firm pays the same unit tax as the most delinquent and vicious polluter. Nonetheless, the tax comes as close to the Pigouvian prescription as anything we might expect to find north of the Potomac. As Turvey suggested, passage of the initial legislation

[3]On this and additional discussion of White House strategizing, see White (1981, pp. 145–59).

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did not end the struggle by environmentalists and others who worked the halls of Congress.

Close examination of the Superfund tax reveals other public choice predictions. Disregarding risk assessment and marginal social cost, the 1980 law required that EPA specify at least 400 cleanup sites (about one for each congressional district) and that each state would have its worst site—no matter how risky in a relative sense—included in the 400. Put differently, the law had the immediate and politically valuable effect of generating excess demand for congressional services. This inspired new local interest groups to organize lobbying efforts. McChesney's point comes through.

Going on, the law specified that all firms presumed to have contributed to a Superfund site will bear joint and several liability for the cost of cleanup. Theoretically, the firm with the deepest pockets and largest amount of brand name capital at risk may bear all the cost, even though its waste contribution is slight. Visions of efficiency are quickly replaced by political rent seeking.

There is a saving grace in all this, for some firms. The joint and several liability feature has led to the sudden demise of privately provided environmental liability insurance (Katzman 1985). Private insurers cannot estimate the risk faced by a particular firm, since the firm may be found liable for another firm's actions. Chemical firms have little choice but to self-insure, which provides a large-firm advantage (U.S. General Accounting Office 1987). Superfund has the effect of restricting output and limiting entry. Buchanan and Tullock ride again.

Like most large environmental endeavors of the past, the Superfund program became ensnarled in bureaucratic red tape and management problems. The culmination of that was seen when Rita Lavell, the EPA director of Superfund programs, was convicted of perjury before Congress after being charged with allocating Superfund dollars in ways that promoted the political fortunes of Republican candidates for Congress (Florio 1986). Pigou would turn over in his grave.

Empirical Evidence on the Fund Operation

The allocation of Superfund resources through EPA's designation of sites has been studied by Harold C. Barnett (1985) and McNiel, Froshee, and Burbee (1988). Barnett built a statistical model for predicting the level of Superfund expenditures across the 50 states in which he used elements of EPA's criteria for ranking the riskiness of sites with respect to surface water, air pollution, and ground water and where he included other variables having to do with state support

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of remedial action as well as regional variables. Barnett reports one puzzle. Where the risk of ground-water contamination is high, EPA has allocated a smaller amount of its budget. Ground-water contamination was one of the chief reasons for establishing Superfund.

McNiel, Foshee, and Burbee examine the relationship of contributions to Superfund from in-state industries and the redistribution of those funds through Superfund. If contributions are risk-based, one would expect that to be reflected by use of Superfund dollars for the repair of sites in states where large amounts of fees are collected. The pollution in question does not migrate great distances. The research finds nothing of the sort. For the most part, Superfund payments are highest in the Southwestern U.S., where the petrochemical industry is concentrated. Superfund expenses are highest in the Northeast. It turns out that payments to the fund are not related to state personal income, to past problems with hazardous waste sites, or to funds obligated to the state through the program. The research suggests Superfund is a complex system for redistributing funds in a hazardous waste framework.

Revisions and Adjustment

The tensions between bureaucrats who allegedly allocated funds on a political basis and elected politicians who see redistribution as their domain as well as other Superfund problems led to the Superfund Amendments and Reauthorization Act of 1986. SARA tightened the leash on EPA, increased appropriations and the taxes to fund the program, expanded the coverage of sites and the list of harmful pollutants, and required that chemical producers provide detailed information to local communities on the chemicals used and produced in each and every plant.

As if recalling Turvey's point and going one better, SARA authorizes private parties to petition EPA to perform risk assessments on any site, whether or not the site has earned a priority standing. SARA also provides funds to private parties to sue EPA when the agency fails to classify a site as being hazardous. There's a post-equilibrium subsidy in place, one that ensures an increase in demand for Superfund action.

In March 1988, the average cost of cleaning Superfund sites was approximately $25 million ("Current Developments" 1988). At that rate, some $20 billion will be needed to handle the 951 sites now listed for cleanup. There is $8.5 billion in the fund, and 27,000 additional candidate sites are waiting to be included in the program. When we recall that demanders of the program pay no fees, indeed are subsidized, it is little wonder that the quantity of services they

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demand would increase, along with the tax on feedstocks. To cap it all, EPA has expressed concern about the logic of the program on risk reduction grounds (U.S. EPA 1987). It seems that other, far more crucial and less costly problems have been pushed to one side by congressional interest in the politically more appealing Superfund program.

The Superfund story is just one episode involving environmental user taxes, hardly enough to serve as convincing evidence that fees will always be perverted in the political process. However, it is a major episode, one involving billions of dollars and the entire U.S. economy. Yet while we might be cautious in drawing general conclusions from this one episode, Congressman James J. Florio, a major supporter of the program, is not so bashful. After writing extensively about the experience with Superfund, Mr. Florio (1986, p. 379) stated: "When issues are brought before Congress, disagreements quickly become political and sensible environmental policy may be lost in the process." He could just as well have said that efficiency arguments always tend to give way to special interest demands for redistribution.

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BOOK REVIEWS

The New Politics of the Budgetary Process
Aaron Wildavsky
Glenview, Ill.: Scott, Foresman & Co., 1988, 468 pp.

Aaron Wildavsky's 1964 book on *The Politics of the Budgetary Process* deservedly proved to be a classic. Other scholars had observed the decentralized "bottom-up" congressional budget process and saw only disorder. Wildavsky, however, observed that the results of this process seemed quite orderly: Budgets were usually approved on schedule (by June 30 in those years), and total federal spending was roughly equal to tax revenues except during wars and recessions. The major contribution of Wildavsky's "Old" *Politics* was to explain the mutual expectations, rules, and strategies that led this decentralized process to produce order without direction. In that sense, Wildavsky was the Adam Smith of the federal budget process. In addition, Wildavsky's writing was clear, lively, relatively free of professional jargon, and it reflected a "jeweler's eye" for institutional detail—making the "Old" *Politics* (through four editions) readable by both students and budget specialists with other professional training.

The set of conditions that made the "Old" *Politics* "work," however, has changed substantially. The more important of these conditions are the following:

- The erosion of the consensus for balanced budgets, associated first with the increasing influence of Keynesian economics, and later with the 1981 Reagan initiatives to increase defense spending and reduce tax rates.
- The rapid increase in "entitlement" spending, most of which is not subject to annual appropriations.
- The rapid increase and subsequent decline in inflation.
- The "democratization" of Congress, reflected in the erosion of seniority and the proliferation of subcommittees.
- And most important, the erosion of the consensus about what the federal government ought to do, as reflected in increasing disputes about the budget "base."

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The congressional budget process, in part in response to the above changes, has also been modified substantially. The Congressional Budget Act of 1974 established a "top-down" budget process, implemented by a comprehensive budget resolution developed by a new budget committee in each house, and supported by the new Congressional Budget Office. The Impoundment Control Act of 1974 severely restricted the president's authority to impound spending for any purpose, authority that was further restricted by a 1983 court decision. And the Balanced Budget and Emergency Deficit Control Act of 1985 (popularly known as the Gramm-Rudman-Hollings Act) established a statutory deficit reduction schedule and procedures for implementing that schedule. These new processes were supposed to implement a "top-down" perspective on the budget, but they did not fully replace the "bottom-up" processes of the "Old" *Politics*.

Most of Wildavsky's *New Politics* explains and evaluates these new processes. As a consequence, this is almost entirely a new book, although it fortunately includes an efficient summary chapter on Wildavsky's insights about the strategies and calculations of classical budgeting. In contrast with the "Old" *Politics*, the theme of the *New Politics* is about direction without order. Although the new processes were designed to achieve better control of the budget totals, the outcomes of the budget process are now much less orderly. The federal budget has only rarely been approved on schedule (now September 30) despite a rapid increase in the share of congressional time addressed to the budget. Total federal spending and the deficit, until recently, increased at a rapid rate. And all participants are frustrated about both the process and its outcomes.

Wildavsky does not attribute these outcomes to the new processes but rather to what he perceives (I believe correctly) as an erosion of consensus about the appropriate role of the federal government. A good process can elicit a budget agreement when there is some consensus, but a change in the budget process cannot force a consensus that does not exist.

Wildavsky is appropriately skeptical about most recent and proposed budget "reforms"—specifically including program budgeting, zero-based budgeting, sunshine and sunset laws, capital budgeting, multiyear budgeting, and the line-item veto—primarily because they abstract from the politics of the budget process. On the other hand, Wildavsky has long supported a constitutional amendment to limit total federal spending and borrowing. With or without such an amendment, he strongly favors adoption by the House of the new Senate "offset" rule that requires that any committee proposal that exceeds the spending guidelines in the first budget resolution be paired with some specific spending cut or tax increase so that the combined proposal is deficit neutral. Use of this offset rule is the primary reason that the Gramm-Rudman process has been more effective in limiting total federal spending than anyone anticipated.

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Wildavsky has some nostalgia for the "Old" *Politics*, but he recognizes that the current budget process is more complex and more frustrating primarily because the federal government is now more complex in ways that are not supported by a broad consensus. In contrast to those who propose "rationalist" reforms of the budget process, Wildavsky would not replace the politics of the budget process but would change the institutions and rules by which politics leads to agreement.

The *New Politics* is more complex and more difficult than the "Old" *Politics*, but that is because the world has changed. For those who want to understand the new politics of the budgetary process, however, Wildavsky's *New Politics* will be the definitive guide, both to the expected budget outcomes and the potential for improving this process.

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World Tax Reform: A Progress Report
Joseph A. Pechman, ed.
Washington, D.C.: Brookings Institution, 1988, 249 pp.

Tax policy is seemingly forever and everywhere in flux. Recent U.S. tax reforms have been part of, and have given further impetus to, an unusually active wave of international reform efforts. Joseph Pechman's *World Tax Reform* offers a useful country-by-country guide to the state of national tax systems and reform efforts.

The strength of this volume is that each of the contributing authors is well qualified to report on the status of his assigned country's tax reform efforts. Each country's report is well written, providing enough statistics to explain without overwhelming, and each report is accompanied by a discussant's paper providing another viewpoint. For a discussion of tax reform, the text is very readable overall.

The book is not without its flaws, however. Its main flaw is that it lacks balance in the range of views presented. Many of the authors have, to one degree or another, Pechman's strong preference for raising tax levels to fund social programs and for shifting the tax burden from less wealthy to more wealthy taxpayers and from labor to capital income. These are not the views that guide the current tax reform movement; they are the views that led to income tax systems badly in need of reform.

Increased social spending and the resulting increases in revenue requirements in the 1960s and 1970s led to ever-higher marginal income tax rates. Higher tax rates led to wide arrays of deductions, exemptions, and credits that reduced the growing distortions of economic decision-making created by the increases in tax rates. These tax abatements were perceived, and most often misperceived, as tax loopholes that led many taxpayers worldwide to believe their nations' tax systems were unfair and unnecessarily complicated.

The central theme of recent income tax reform has been to reduce income tax rates to create a more neutral tax code and thereby to reduce

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tax disincentives to work, save, and invest. Unfortunately, the resulting tax revenue losses have been offset by base broadening, that is, by repealing or reducing deductions and exemptions that frequently were useful in offsetting the income tax bias against saving and capital formation. Base broadening, therefore, offset the gains in tax neutrality from lower tax rates. The recent tax reform in the United States, for example, featured significant rate reductions and base broadening. It also shifted, virtually at random, massive tax burdens among taxpayers with no discernible net gain with respect to equity, neutrality, or simplicity.

The albatross of tax reform is the lack of generally accepted definitions for equity, neutrality, and simplicity. The lack of consensus on what is meant by tax neutrality has been particularly troublesome. For example, Pechman defines neutrality with respect to the recipient of income or economic gain, continuing a long tradition of misapplying to tax policy the Haig-Simons definition of income as net accretions to wealth. This definition appears to be employed by many of the authors in the text, including Sigjren Cnossen, who argues that neutrality is achieved when equivalent tax burdens are imposed on earnings and gains when received by an individual, and when equivalent tax burdens are imposed on earnings and gains received by similarly situated individuals.

Pechman's definition of neutrality is particularly well suited for redistributing income. It often leads, however, to very peculiar statements when tax neutrality and economic growth are at issue. For instance, Claes Ljungh, in his discussion of the Swedish tax system, argues that future tax reform "should be more favorable to savings." And yet his next sentence states, "The changes (in the tax system) should result in an increase of the revenue from capital gain and other income from capital." Capital income is the return to saving. It is a strange definition of neutrality that argues that the more you tax saving, the more taxpayers will save.

By contrast, the supply-side definition of neutrality is that a neutral tax leaves unaffected the relative prices of goods and services when compared to what these prices would be without the tax. A neutral tax, therefore, does not distort the price signals that guide economic decisionmaking and resource allocation. In contrast with Pechman's definition of neutrality, which proceeds from the perspective of the recipient of income, the supply-side definition proceeds from the perspective of the source of earnings and gains.

The supply-side definition of neutrality, unlike Pechman's definition, is well suited to guide tax reform efforts intended to minimize tax barriers to economic growth. Recent U.S. income tax reforms have relied on the supply-side definition, though they have failed to implement it consistently. Starting in 1979, the United Kingdom began a series of supply-side reforms of its tax system that removed some of the impediments to market efficiency. The continued economic expansion in both the United States and Great Britain is attributable in part to the successes achieved in applying supply-side principles to tax policy. Given the central role

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that supply-side principles have played in guiding many countries' tax reform efforts, one would hope that future reports on world tax reform will give the supply-side arguments greater attention.

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Liability: Perspectives and Policy
Robert Litan and Clifford Winston, eds.
Washington, D.C.: Brookings Institution, 1988, 241 pp.

One of the most persistent problems in public policy is the public's notoriously short attention span. The liability insurance crisis provides an excellent example. In 1986, the national media were filled with reports of skyrocketing liability insurance premiums forcing products off the market, driving doctors from their practices, and forcing the closure of day care centers, swimming pools, and boy scout camps. Spurred by the crisis, innumerable academics and policy experts turned their attention to exploring the causes of and devising potential solutions to the liability problem. Before much of this work could be completed, however, the problem had faded to the back pages of the newspapers and the backs of the public's minds. The liability system's problems were far from resolved, but insurance premiums had leveled off, and attention turned elsewhere.

We now are beginning to see the fruits of much of the research that was spurred by the crisis. Among these works is *Liability: Perspectives and Policy*. One hopes this book will receive serious attention by policymakers, despite the fact that the tort system is no longer the crisis of the moment. Editors Robert Litan and Clifford Winston, both senior fellows at the Brookings Institution, have gathered some of the nation's foremost experts on liability to explore the causes of and potential cures for the problems of the liability system. While the book is somewhat disappointing because of the subjects and ideas it does not adequately address, it nevertheless contains a wealth of data and insights concerning a broad range of insurance and liability issues. It should prove extremely useful to policymakers and other students of this still-important issue. Among the highlights are John Calfee and Clifford Winston on the economic efficiency of various liability rules; Scott Harrington on prices and profits in the liability insurance system; Patricia Danzon on medical malpractice; Peter Huber on environmental hazards; W. Kip Viscusi on occupational accidents and illnesses; and George Priest on product liability and the accident rate.

Calfee and Winston, after devising an economic model to measure different liability rules, find that no single rule is optimal in all circumstances.

Harrington provides a comprehensive description of the liability insurance industry and how it has functioned in recent years. He concludes

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that the recent jump in insurance rates was the result of real losses, rather than mere profiteering by insurance companies. Moreover, he finds that attempts to regulate the industry—either directly or through the antitrust laws—could make things worse.

Danzon documents the recent increases in the number and severity of malpractice awards—especially those against specialists such as obstetricians. After surveying current malpractice rules and proposed alternatives, she also gives qualified endorsements to the establishment of firm schedules of damages for specified injuries and to lengthening the statutes of limitations applying to medical malpractice suits.

Huber, author of his own recently published book on liability, walks the reader through the hazard-filled and bizarre world of environmental torts, ranging from asbestos to x-rays. Working with some complex issues, he takes what could have been a deadly dull tome and makes it a fascinating story, describing the steady expansion of liability for environmental hazards over the years. Huber points to some potential solutions, such as a revival of a causation requirement, a renewed judicial respect for the language of insurance contracts, and increased regulatory, as opposed to judicial, control of environmental hazards. However, he sees such steps as unlikely in the near future.

Viscusi departs from the book's focus on civil liability and reviews the mechanisms, from worker's compensation to direct regulation, that are used to prevent and compensate for on-the-job injuries. According to Viscusi, however, the chief mechanism for ensuring worker safety is the market itself, as workers continually express their preferences for safety. Viscusi maintains that while sometimes useful, civil liability is a minor and often inefficient way to prevent accidents.

Priest, after reviewing accident rate data, finds no discernible positive effect on safety due to product liability law. He also examines selected product cases and finds that by compensating consumers who may have prevented their own injuries, product liability law may actually increase the accident rate.

These articles shed light on the problems of the liability system. Nevertheless, the reader may be frustrated because of the subjects and ideas that are not addressed. This shortcoming is even more annoying because many of the authors in this book have been pioneers in exploring the neglected areas. For instance, very little is said about how the liability system tends to stifle innovation and thus hinder rather than enhance safety improvements, as Huber has eloquently and thoroughly documented elsewhere. Nor is there much discussion of the tort system's tremendous inefficiency as a system of insurance, although Priest is perhaps the leading expert on that topic. Both of these issues would seem to be crucial to any exploration of liability problems.

Perhaps the book's most glaring omission is its lack of any serious discussion of the possibility of consumer choice of liability rules. Both Huber and Priest have argued forcefully elsewhere that consumers should

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not be forced to accept the mandatory insurance contract offered by tort law. Where there is a preexisting contract between the parties, a possibility in both the product liability and medical malpractice areas, the parties involved should be able to specify for themselves the duties each assumes toward the other. In this way, liability rules could be set by market processes rather than by judicial fiat.

Little is said in the book about this market-process option. Huber and Priest devote their space to other subjects, and while Calfee and Winston indirectly mention it, they dismiss the market option because of a perceived lack of consumer information. Several other authors deal with the concept in an even more cursory fashion. The idea of consumer choice is not yet generally accepted, but one would think it would appear more prominently in a book surveying liability reform options.

Although the tort crisis has dropped from the headlines, the U.S. liability system is still in serious need of reform. Despite its failings, this book could make a valuable contribution to that reform effort, as it provides both an overview of the subject and useful facts and figures for policymaking.

James L. Gattuso
The Heritage Foundation

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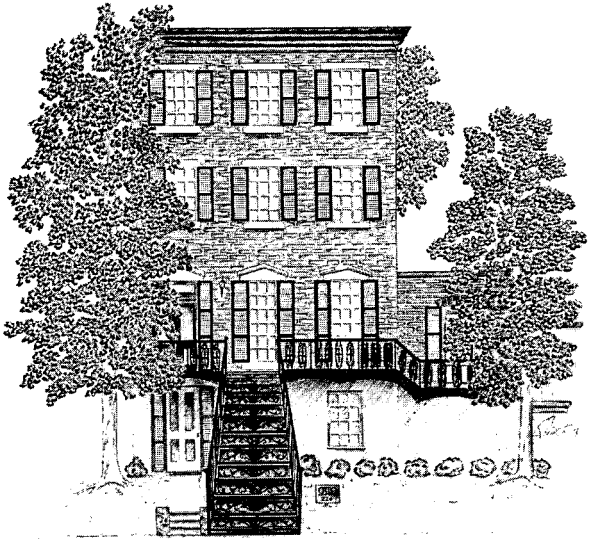

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ON SPONTANEOUS ORDER IN CHINA

Govern the state with correctness. . . . Administer the empire by engaging in no activity. . . . The more taboos and prohibitions there are in the world, the poorer the people will be. . . . The more laws and orders are made prominent, the more thieves and robbers there will be. . . . Therefore the sage says: I take no action and the people of themselves are transformed. . . . I engage in no activity and the people of themselves become prosperous.

—Lao Tzu

Quoted in Wing-Tsit Chan,
A Source Book in Chinese Philosophy
(Princeton: Princeton University Press,
1969), pp. 166–67.

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